

FINANCE MANUAL

NATIONAL
MINORITY
AIDS
COUNCIL



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NATIONAL
MINORITY
AIDS
COUNCIL

300 EYE STREET, NE
SUITE 400
WASHINGTON, DC 20002-4389
(202)544-1076
FAX (202)544-0378



Dear Colleagues:

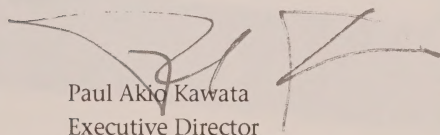
Although the AIDS statistics show that the number of cases will continue to climb, the resources allocated by government and private sources will not match the demand for education programs and for services for those already infected. Due to this leveling in projected funds to fight this epidemic, only those community based organizations that are able to maximize their resources and operate more efficiently will receive continued funding to continue serving their communities.

The National Minority AIDS Council was created in 1987 to develop leadership within communities of color to address issues of HIV infection. It is our belief that, given the right resources, people of color will be able to fight effectively against HIV in our communities. Our work in technical assistance and skills building is part of this commitment.

The purpose of this Financial Management Manual is to provide one more tool for community based organizations to manage the complexities of financial systems. We wanted to provide a quick reference for managers and board members without financial experience to use in all aspects of strategic planning and program administration. We hope that this manual will be helpful to you.

We would like to thank Jude Kaye and Jan Masaoka of the Support Center of San Francisco, who produced this manual under impossible deadlines, Barbara Miller of the Support Center of New York for her insight in the conceptualization and execution of this manual, Carol Shilling, for her work on the exhibits, Ken Dean of NMAC for spending countless hours with the manuscript, Eugenia Kim for her layout work and creativity which has made this manual much more fun to read, and Carlos Vélez, Esq., Deputy Director for Programs of NMAC, for his work in reviewing and editing the contents of this manual.

This manual is dedicated to all bookkeepers and accountants who daily watch the numbers to ensure the financial health of our organizations. I salute your efforts, for you are a critical component in the fight against AIDS.



Paul Akio Kawata
Executive Director

300 EYE STREET, NE
SUITE 400
WASHINGTON, DC
20002-4389
TEL 202-544-1076
FAX 202-544-0378

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OAKLAND, CA
EXECUTIVE DIRECTOR
PAUL AKIO KAWATA

ABOUT THE AUTHORS

The authors of this manual are Jude Kaye and Jan Masaoka, both senior staff consultants for the Support Center of San Francisco. Jude has extensive consulting experience with a variety of nonprofit organizations in the areas of financial management, supervisory training, effective meetings, and organization development. She is a nationally recognized trainer who has taught management skills to over 8,000 staff and board members. Jan specializes in accounting systems, financial management, financial planning and computer use for nonprofit organizations. She has published several articles on "Computers and Nonprofit Accounting," is a Lecturer in Golden Gate University's Public Administration Program.

The Support Center of San Francisco is part of Support Centers of America. Founded in 1971, the Support Center is the country's oldest and largest provider of nonprofit management training, consulting and information. It is a 501(c)(3) tax-exempt organization whose purpose is to increase the effectiveness of nonprofit organizations. The Support Center has offices in 14 cities throughout the country, including the National AIDS Support Center located in Santa Fe, New Mexico. Other cities include: Atlanta, Boston, Chicago, Houston, Newark, NJ, New York City, Oklahoma City, Palo Alto, CA, Providence, RI, San Diego, San Francisco, Tulsa, and Washington, DC.

For more information, call the Support Center near you, or contact the Support Center's National Marketing Director at 202-296-3900.

The authors would like to thank Barbara Miller from the New York Support Center, for her invaluable input into the manual, Carol Schilling for her help with the financial statements and Jennifer Hamilton of Hall, McCormick & Darling, San Francisco, for her assistance in editing it. Thanks are due also to those whose ideas and articles have helped in developing these materials: Peat Marwick, Price Waterhouse especially Dick Larkin, and Tom Lamothe.

Jude Kaye and Jan Masaoka would also like to thank the National Minority AIDS Council for recognizing the need for a financial management manual for AIDS organizations and the willingness to support the endeavor.

If you have any suggestions or comments about the manual, please address them to: Jude Kaye and Jan Masaoka, Support Center of San Francisco, 70 Tenth Street, San Francisco, CA 94103. Telephone: 415-552-7584.

This manual can be reproduced for use within their agencies by any members of the National Minority AIDS Council and the National Association of People With AIDS. All others are requested to contact the authors for permission to copy.

Founded in 1971, the Support Center is the country's oldest and largest provider of nonprofit management training, consulting and information.

NATIONAL MINORITY AIDS COUNCIL

The National Minority AIDS Council (NMAC) is dedicated to developing leadership within communities of color to address issues of HIV infection. A member organization founded in 1987, NMAC has responded to the needs of communities of color by developing five projects aimed at enhancing the skills necessary to challenge this health crisis.

Public Policy Education Program

To increase the involvement of people of color in the decision-making process at the national, state and local levels, the NMAC Public Policy Education Program teaches the development of effective public policy to leaders in communities of color. As part of NMAC regional trainings, members of community agencies learn the mechanics of the legislative process, how to obtain support from their communities and how to form effective coalitions. The program also provides information on recent developments in the area of HIV public policy, and community agencies receive timely information from regular NMAC meetings with congressional, administration and community leaders.

National Skills Building Conference

This annual conference provides members of community agencies with the skills necessary to improve the performance of their agencies and programs to render better services to their communities. The 1991 conference, held in Los Angeles, was cosponsored with the AIDS National Interfaith Network (ANIN) and the National Association of People with AIDS (NAPWA) and brought together individuals from these very diverse communities to participate in over 125 seminars on subjects ranging from fundraising and human resources to the effects of grieving in the AIDS workplace.

Computer Partnership Grant

Through this program funded by Apple Computer, members of minority community based organizations and PWA coalitions receive computer hardware and software necessary to produce high quality print materials in-house, and perform automated accounting and bookkeeping. Recipient organizations also receive training on the use of the computer systems. Administered in conjunction with NAPWA, this program distributed 70 computer systems in 1990 and 1991.

Regional Trainings

NMAC sponsors three regional technical assistance trainings annually. Through these trainings, minority CBOs increase their organizational capacity via skills building and support. Regional trainings include financial management, fundraising, computer training, and public policy roundtables.

Publications

NMAC also produces and distributes two newsletters and technical assistance manuals. The NMAC Update focuses primarily on public policy and the NMAC T.A. Newsletter focuses primarily on technical assistance. Technical assistance manuals include the Computer Manual, Public Policy Primer, and Volunteer Program Development Manual.

For more information on how you can be a member of the National Minority AIDS Council, please contact our Washington, DC office at (202)544-1076.

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HOW TO USE THIS HANDBOOK

This is a different kind of "how to" book. Instead of "how to keep books" or "how to account for restricted funds," this handbook is *not* directed mainly at accountants or staff directly involved with accounting. This handbook is for executive directors, program managers, and board members who are responsible for crafting financial strategy, for ensuring financial accountability, and for monitoring financial and program performance.

As a manager, you already know what reports to give to foundations and constituents about your program accomplishments. This handbook should help you know what **financial** reports are required by government funders and the IRS.

As a manager you are experienced in staffing and overseeing programs; this handbook will help you learn how to staff and oversee accounting and financial functions.

As a manager you anticipate problems in program services or in staff operations; this handbook will help you read financial statements to anticipate financial problems and to use budgets for better planning and control.

Start by reading the introduction about nonprofit organizations and financial management responsibilities. Then choose a section from the Table of Contents that is most important to your work now. In short, think of this book as someone to turn to for advice occasionally rather than as something to read straight through and then put on a shelf.

This handbook is for those who are responsible for crafting financial strategy, for ensuring financial accountability, and for monitoring financial and program performance.

INTRODUCTION TO FINANCIAL MANAGEMENT IN NONPROFIT ORGANIZATIONS

Today almost one million nonprofits operate in the United States, employing nearly one seventh of America's workers.

Nonprofits range from community-based AIDS organizations and local theatres to large, powerful organizations such as Harvard University, Blue Cross, and the American Association of Retired Persons.

Nonprofit organizations are granted tax-exempt status to enable them to provide services in the public interest. In exchange for such privileges as exemption from federal and state income taxes and the ability to solicit tax-deductible contributions, these organizations are expected to perform their programmatic functions in an effective, efficient manner. Both internal and external readers of financial information want to see how effectively and efficiently resources are used to meet program goals.

Internally, sound financial information is used to:

- guide decision-making about programs
- project revenue and expenses
- engage in planning
- identify areas for improvement in efficiency
- anticipate financial problems
- suggest strategies for financial stability.

Accurate financial information provides information to enable the nonprofit manager to make better decisions faster.

Externally, sound financial management allows the organization to be accountable to:

- funding sources
- government agencies
- regulatory and tax bodies (such as the Internal Revenue Service)
- individual and corporate contributors
- the organization's constituency
- the general public.

Financial information is generated from the accounting system. The financial manager uses that information to guide operations to make the best possible use of the organization's financial resources to achieve its goals.

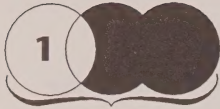
Readers of financial information want to see how effectively and efficiently resources are used to meet program goals.

Financial activities in nonprofit organizations

Financial activities can be grouped into three areas:

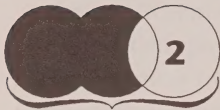
1. Transaction handling and record-keeping
2. Planning & budgeting
3. Financial management

These areas are outlined in the diagram in Exhibit 1.



Transaction handling and record-keeping is the bookkeeping/accounting area of financial activity. Checks must be written to pay bills; incoming checks must be deposited; an ongoing record of financial activity is kept. Concerns in this area include:

- Timely and accurate billing and payment of bills
- Prompt deposits of receipts
- Proper authorization of payments
- Accurate recording of transactions
- Timely and accurate preparation of financial reports



Planning & budgeting are those processes whereby the organization sets goals and objectives, chooses programs, and decides how those programs will be operated. Budgeting is a process that relies both on financial information about past performance and the organization's future plans. Concerns in this area include:

- Involving people appropriately in the budget process
- Considering both internal and external factors in budget development
- Using past and current information to develop realistic projections
- Agreement on the use of the budget in managing ongoing operations



Financial management is the management of current financial operations based on analysis of financial information and knowledge of the organization's objectives and plans. The financial manager oversees and directs the accounting process and participates in budget development and revision. In addition, the financial manager is responsible for such activities as cash flow management, cost allocation, cost analysis, and asset management. Concerns for the financial manager include:

- Anticipation of financial problems
- Maximizing use of financial resources
- Ensuring tax compliance and compliance with funder requirements
- Providing meaningful information to program managers

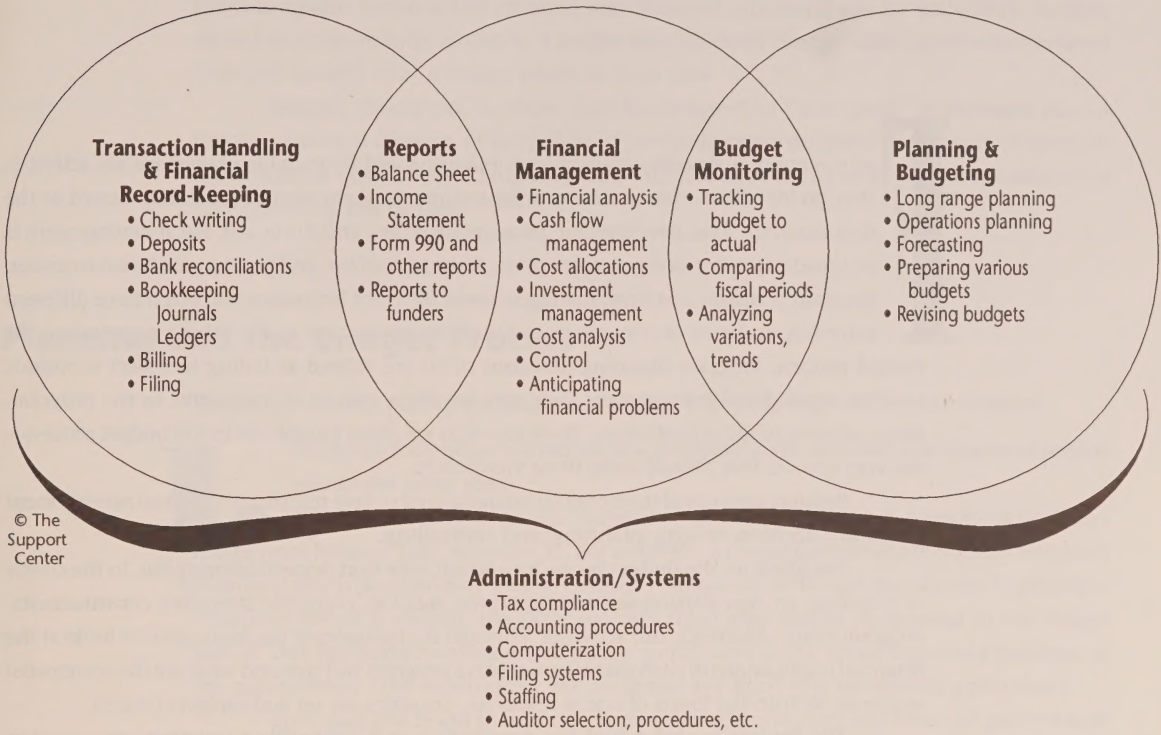


Administration of the fiscal office is developing the staffing and organizational systems to accomplish the above functions. Questions include:

- Should we hire a bookkeeper or contract with an outside bookkeeper?
- Should overall financial management be done by the executive director or do we need a finance director?
- What accounting software should we employ?
- Do we need an audit and, if so, how do we choose an auditor?

Such administrative systems are not financial functions by themselves, but are the kinds of management questions that the organization needs to supervise the accounting department.

EXHIBIT 1
Financial Activities in Nonprofit Organizations
Examples of activities within various functional spheres



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Each area of financial activity is very different in one organization than in another. For example, while all organizations need a bookkeeping system, a small educational organization needs a much simpler system than does a large health clinic. At different times an organization will face different financial issues. For example, one year an organization may be expanding, in the another consolidating operations, and in some years contracting. At some points an organization may be focused on cost control, while a year later its financial focus may be on better collection of pledges.

Financial resources are a key part of any organization's ability to be effective. Through understanding and taking control of those resources the organization takes control of its financial future.

BUDGETING

What is a Budget?

For too many nonprofit organizations, planning and financial management are activities that divide rather than unite the organization. Program planning is often viewed as the domain of the executive director, program directors, and the board. Fiscal management is assigned to the bookkeeper, accounting, finance director, and perhaps the board treasurer. Program planners and fiscal managers speak different languages and often have different priorities, and may or may not be aware of the importance of the other's approach to the budget process. Program planning decisions often are viewed as failing to reflect economic realities, while fiscal management decisions are often viewed as insensitive to the programmatic mission of the organization. These conflicts are often fought out in the budget process—the very process that should unite these viewpoints.

Budgets are tools of the financial management system used for two central management functions: decision making (planning) and controlling.

Deciding on the budget is one important way that organizations plan. In the course of planning, an organization defines its purpose, mission, corporate strategies, constituencies, program goals, objectives, and activities. Through the budget process, management looks at the financial implications of their plans: how much a program will cost and what are the anticipated revenues. Within the limits of scarce resources, priorities are set and budgets created.

The budget is also a tool for monitoring and controlling ongoing organization activity. Once a plan has been developed, the organization needs information to see whether it is keeping to its plan. If the organization has gone “off the track,” various responses can be

Program planners and fiscal managers speak different languages and often have different priorities, and may or may not be aware of the importance of the other's approach to the budget process.

considered. Since the budget describes the plan in terms of dollars, it provides a basis for monitoring progress. If, for example, a program is costing more than anticipated, it may be necessary for management to bring costs down, or it may be decided to review the plan to take a higher level of expense into account.

A budget can be thought of as the organization's plan of action, expressed in dollars. A budget describes and estimates the expected income from revenue sources and the expenditures which the organization will need to make to achieve its program objectives.

Since a budget is a planning document, effective budgets are those which accurately anticipate and project the interplay between program and fiscal activity. **This is one reason more organizations choose to include projected service statistics in the budget documents.** Budgets do not simply mandate an amount of money to be spent by a certain date. **Instead, an**

effective budget serves as a guideline which reflects management's best estimate of the anticipated revenue and the costs of operating various program activities.

Budgets should not be documents which are developed each year, only to be filed away until the next year. They should be useful tools, used to anticipate problems and to provide a baseline against which actual program and financial experience can be monitored. Budgets should be designed to be modified. A budget which is never changed (like a plan which is never changed) is likely to be a budget which is never used.

Budgets should not be showy façades designed to "look good" to someone else—a funder, a board, a director, or the public. When budgets are designed to create an impression rather than as expressions of program plans, they lose their ability to assist the organization in both planning and control.

Planning and the Budget Process

See Exhibit 2 (next page) for a diagram of the ten-step budget process described below:

1. Establish the budget period; review program achievements and financial performance for prior year.

The first task in developing a budget is to select a budget period. A budget period need not be from January 1 to December 31. For example, an organization whose primary activity is a summer youth program may find an October 1-September 30 budget period most appropriate. Whatever period is chosen, the organization's fiscal year should correspond to the budget period. This facilitates comparisons of budget projections to the actual financial experience of the organization. (The government will recognize any fiscal year for reporting purposes.)

Both staff and board should review program achievements and financial performance for the prior year. This would include, but not be limited to reviewing objectives achieved, program statistics and cost per unit of service, and comparing prior year's budget to actual.

2. Set goals and objectives for the budget period.

The organization should develop (or review and revise) its long range plan, and then develop a list of program or organizational objectives to be achieved during the year. The organization can see how much it will cost to achieve these objectives, and how much more it is likely to cost to meet other objectives in the future. In addition, by defining measurable objectives, the organization can later determine to what extent those objectives have been achieved.

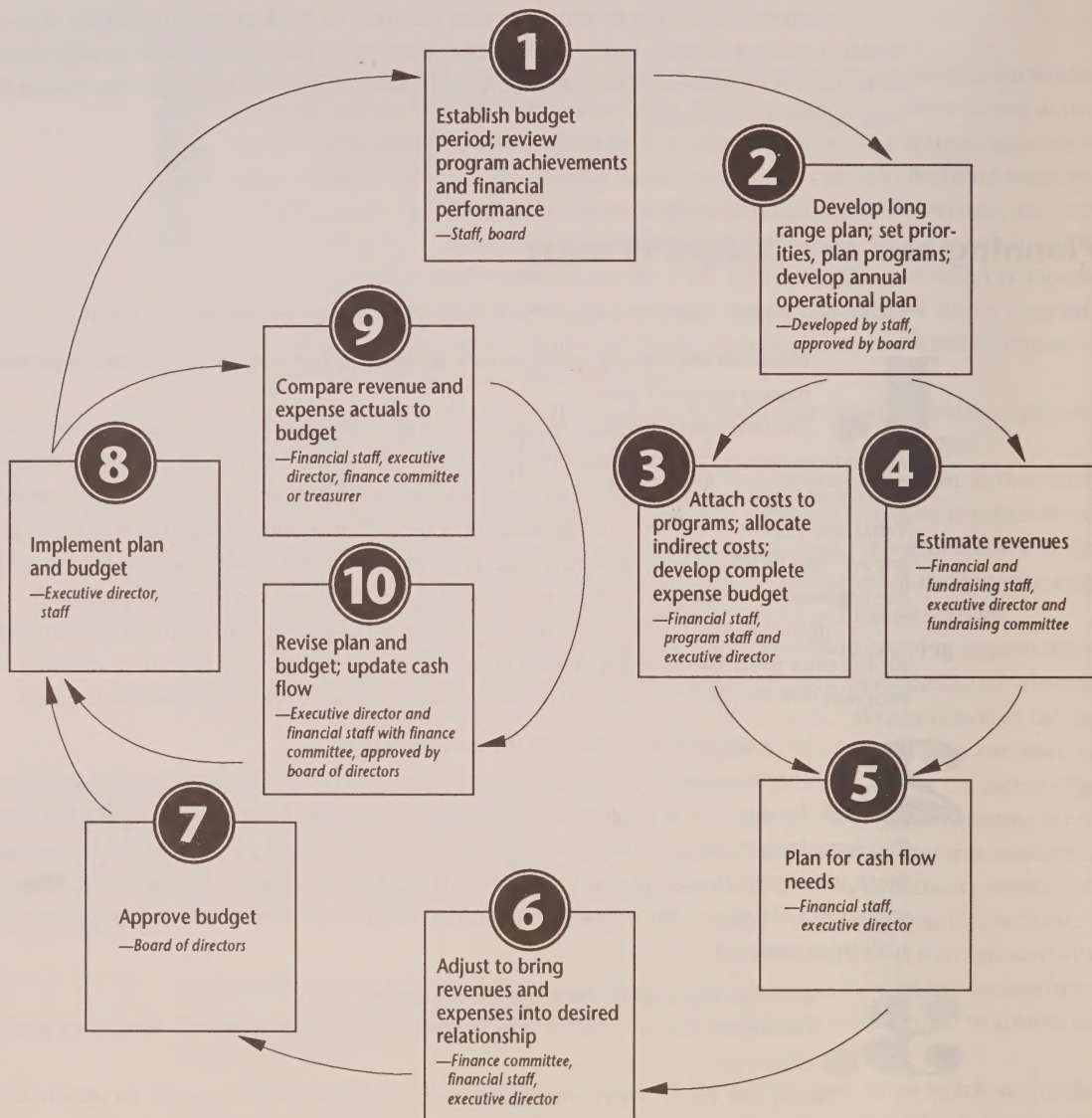
3. Estimate the cost of the required resources.

Determine the number of staff, supplies, and other resources needed to attain objectives.

Based on past experience, determine the resources required to attain the program objectives. If the organization has an ongoing budget process, much of the guesswork can be eliminated by using knowledge gained from previous experience as recorded in past budgets, budget reviews, and financial statements. For example,

EXHIBIT 2 The Budget Process

Some budgeting activities ideally take place before the formal start of the budget process, others during it, and others after the budget has been adopted. A budget calendar should be established, with time frames for each activity, and assignment of responsibilities. This diagram of a budget cycle includes an example of how responsibilities may be designated.



history—as recorded in past budgets—may show that it was originally thought that two full-time staff could serve 500 clients per year, but that it actually required 2.5 staff to do the job. If historical information is lacking or incomplete, call on the experiences of organizations similar to your own. The plan for resource use will be based on your organization's experience, the experiences of other agencies, and current considerations.

In addition to resources directly used for a program, remember that there may be hidden costs required to support a program. For example, if a new program will require ten new staff positions, plans must also be made time to hire, train, and support the new staff, as well as advertising costs, office equipment, etc.

With an ongoing budget process, much of the guesswork in estimating the cost of required resources can be eliminated by using knowledge gained from previous budgets, budget reviews, and financial statements.

In estimating the cost of required resources, the organization must not only determine the direct costs of running a program, but determine the shared or uncommon expenses (also known as “overhead” or indirect costs) such as executive director, bookkeeper,

rent, basic telephone expenses, etc.

To estimate the costs of required resources, use historical information, the experience of others, and research on particular items. For example, since not all costs increase at the same rate, a fixed percentage increase for the entire budget is not an adequate method of adjusting for inflation. Rental contracts for office space or furniture, for example, generally fix costs for some future period. Other costs, such as salaries and benefits, can be accurately estimated by reviewing personnel policies and anticipated increases.

It is important to include all the costs associated with a particular resource. For example, when new staff are called for, costs will include not only salaries, but increases in workers' compensation insurance, employer's FICA, and other payroll taxes, insurance, office space, and furniture. In addition, larger programs and offices require more “systems” and support—such as staff meeting time, office equipment, supervision time, etc.

4. Estimate anticipated revenue.

Just as expenses are planned, revenue must also be planned. Again, historical information, the experiences of others, and current considerations will form the basis for revenue estimates.

Revenue from contributions, special events, and fees can often be accurately estimated by reviewing past experience and adjusting for current plans. For example, revenue from an expanded direct mail campaign can be projected through careful study of previous direct mail experience.

It is more difficult when revenue comes in larger chunks from fewer sources—such as foundations, corporations, and government agencies. After making the most realistic assessment possible, it may be useful to develop contingency budgets for more conservative or optimistic projections of revenues.

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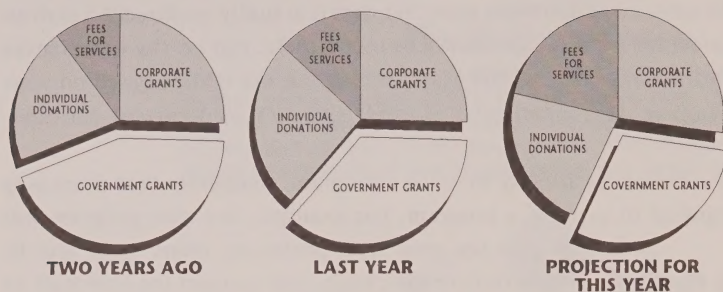


EXHIBIT 3 Revenue Analysis and Projection

This graph illustrates that by analyzing the revenue pattern in prior years, projections can be made to reduce the agency's reliance on one particular source of funding.

5. Plan for cash flow and cash reserves.

In addition to planning for the revenue and expense to support the organization's program objectives, financial resources may need to be committed to the operational objective of financial stability. For example, even if an organization has a "balanced budget," it may not receive the revenue until the end of the budget period, while its expenses may be spread throughout the period. This might result in a shortage of cash in the middle of the budget period. By projecting cash flows through the budget period, cash flow problems can be foreseen and solutions brought to bear.

If cash flow is a recurring or ongoing problem, it may be wise to set aside funds each year to build a cash reserve. Even if cash flow is not necessarily a problem, an organization might consider building a cash reserve of at least 3 months of operating expenses to cover the loss of a major grant or for start up costs for a new program.

6. Adjust to bring revenues and expenses into desired relationship.

Once the initial estimates for revenue and expense have been made, the organization can see whether it has a balanced budget or whether revenue or expense exceeds the other. At different times organizations will choose to incur a deficit during a budget period, realize a surplus, or simply "break even." No rule says that budgets must balance in each budget period. Large deficits can, of course, lead to bankruptcy and an end to the services being provided. Large surpluses may represent an abrogation of responsibility for serving the public interest. For any given budget period, however, the revenue and expense should be in the relationship that the organization chooses, rather than mechanically "balanced."

If a preliminary budget has been prepared and revenue and expense are not in the desired relationship, programs must be re-evaluated and adjustments made. Typically, nonprofit organizations find that their initial projections for revenue and expense anticipate an unacceptable deficit, and either additional revenue must be generated, or programs must be cut back.

When reviewing the revenue budget, it is important to avoid the temptation of raising the estimate without changing the plans for generating revenue. It is not enough just to say, "We'll try harder to raise money this year." A projected deficit *can* be thought of as a "fundraising goal"—but it is not prudent to approve a projected deficit without a carefully planned

fundraising plan that is reviewed on a regular basis. If the fundraising plan turns out to have been unrealistic, budget modifications will need to be made.

If expenses need to be reduced, it is helpful to determine what each program would cost at different service levels. For example, one might find that the cost of providing services for Program A at one-half the current service level results in a decrease in costs by one-third. Don't

Cost-benefit analysis is a tool that an organization may find helpful in making hard decisions regarding cutting or increasing costs.

assume that benefits and costs move together, with each additional dollar spent resulting in an additional dollar of results. "Economies of scale" are present in most projects, and beyond a certain point, additional expenses may bring a dimin-

ished return. As a result, there may be some programs where a large reduction in expenses will result in less reduction in services than in another program.

Cost-benefit analysis is a tool that an organization may find helpful in making hard decisions regarding cutting or increasing costs. Cost-benefit analysis is used to examine the costs required to achieve a certain objective and requires assigning dollar values to the benefits/objectives achieved.

7.

Approve the budget.

While the staff is responsible for developing the budget, the board, acting in its governing role, approves the budget.

8.

Implement plan and budget.

Staff have the responsibility for implementing the plan and budget. The executive director and program directors should agree on what line items program directors are responsible for monitoring and controlling.

9.

Compare revenue and expense actuals to budget.

Reports comparing revenue and expense actuals to budget should be produced in a timely manner (no later than 2-3 weeks after the close of the month) and distributed to those with budget control responsibility, such as the executive director, and the finance committee and/or treasurer. Program managers should receive financial reports for their program so they can monitor their costs and receipts.

10.

Revise plan and budget as appropriate; update cash flow.

A budget should be a guide, not a substitute for decision-making. Therefore, the executive director, working closely with the finance committee and/or treasurer, may consider revising the budget to reflect current financial and program data. The revised budget would then need to be approved by the board of directors.

The budget process is a complex one that can involve the entire organization: executive director, financial and program staff, the finance committee and treasurer of the board, the board's fundraising committee, and the entire board of directors.

Types of Budgets

Salary & Wages	\$
Salary & Wage Deductions	\$
Advertising	\$
Insurance	\$
Rent	\$
Supplies	\$
Postage	\$

Line Item Budget

A line item budget (Exhibit 5), as the name implies, breaks out expected expenses and revenues for a given period in a line-by-line format. Similar categories of expenses and revenues are usually grouped together. These categories might include revenue such as contributions, government grants, fees for service, and expenses such as personnel expense (including line items as salaries, benefits) travel expense, rent, etc.

Each line item is defined as a particular type of revenue or expense. To facilitate the comparison of budgeted amounts to actual amounts, the line items in the budget should correspond to the line items in the organization's Chart of Accounts.

One drawback of a simple line item budget is that it does not distinguish between individual programs within the same organization. At the time of a budget review, it may appear that the organization is doing as expected, when in reality one program where costs are well managed may be offsetting another program where costs are not well managed.

EXHIBIT 4

Sample Line Item Budget

January–December 1991

EXPECTED REVENUE:

Government Grants	\$ 166,638
Foundation Grants	\$ 65,000
Contributions	\$ 28,000
Fees for Service	\$ 6,000
Special Event Revenue (net)	\$ 8,000
TOTAL REVENUE:	\$ 273,638

EXPECTED EXPENSES:

Salaries	\$ 185,000
Fringe/Benefits	\$ 33,300
Occupancy	\$ 9,600
Supplies	\$ 5,400
Postage	\$ 5,800
Equipment	\$ 3,600
Travel	\$ 3,900
Telephone	\$ 6,200
Printing	\$ 3,250
Staff Training/Conferences	\$ 2,200
TOTAL EXPENSES	\$ 258,250

EXCESS REVENUE OVER EXPENSES **\$ 15,388**

Program Budgets

To give more depth to the line item budget, organizations frequently develop separate budgets for each major program. Line items are still used, but they are identified first by program, then summarized for the organization as a whole. A multi-column format best serves this purpose. Program budgets are valuable as planning and monitoring tools since a program's costs and revenue can be evaluated separately and considered in prioritizing among programs. In order to monitor the program's revenues and expenses, the organization's accounting system, however, must be able to provide revenue and expense statements for each program, not just for the organization as a whole. This requires more bookkeeping time and expense. Each organization must decide at which point the detail and expense of the budget process outweighs the benefits that might be gained. See Exhibit 5 below for a sample Program Budget.

EXHIBIT 5

Sample Program Budget

	January–December 1991				
	EDUCATION	COUNSELING	I & R	SHARED REV. SHARED EXP.	TOTAL
EXPECTED REVENUE:					
Government Grants	\$106,897	\$ 19,907	\$ 39,834	\$	\$166,638
Foundation Grants	25,123	11,000	23,377	5,500	65,000
Contributions				28,000	28,000
Fees for Service	1,000	5,000			6,000
Special Event Revenue (net)				8,000	8,000
TOTAL REVENUE:	\$133,020	\$ 35,907	\$ 63,211	\$ 41,500	\$273,638
EXPECTED EXPENSES:					
Salaries	\$ 80,000	\$ 35,000	\$ 49,800	\$ 20,200	\$185,000
Fringe/Benefits	14,400	6,300	8,970	3,630	33,300
Occupancy				9,600	9,600
Supplies	3,000	800	500	1,100	5,400
Postage	1,450		900	900	3,250
Equipment	2,525			3,275	5,800
Travel	1,875	520	120	1,085	3,600
Telephone	1,200	200	750	1,750	3,900
Printing	4,800		600	800	6,200
Staff Training/Conferences	1,025	225	250	700	2,200
TOTAL EXPENSES	\$110,275	\$ 43,045	\$ 61,890	\$ 43,040	\$258,250
Share of Indirect Costs (20%)	\$ 22,055	\$ 8,608	\$ 12,377	\$(43,040)	
TOTAL EXPENSES AFTER INDIRECT COST	\$132,330	\$ 51,653	\$ 74,267	\$ 0	
Excess (Deficit) Revenue Over Expenses	\$ 690	\$(15,746)	\$(11,056)	\$ 41,500	\$ 15,388

Source Budgets

Nonprofit organizations often receive revenue from multiple sources and must prepare budgets for each of those funders. A single line item such as personnel or travel may be paid in part by each of these sources, and the organization may find it advantageous to prepare a source budget that details major funders, and what portion of each line item has been budgeted to that funder. The accounting system is normally set up to track revenue and expenses by program or fund, not source, so subsidiary journals may be developed to track an individual funder's budget line items. See Exhibit 6 below for a sample Source Budget.

EXHIBIT 6

Sample Source Budget

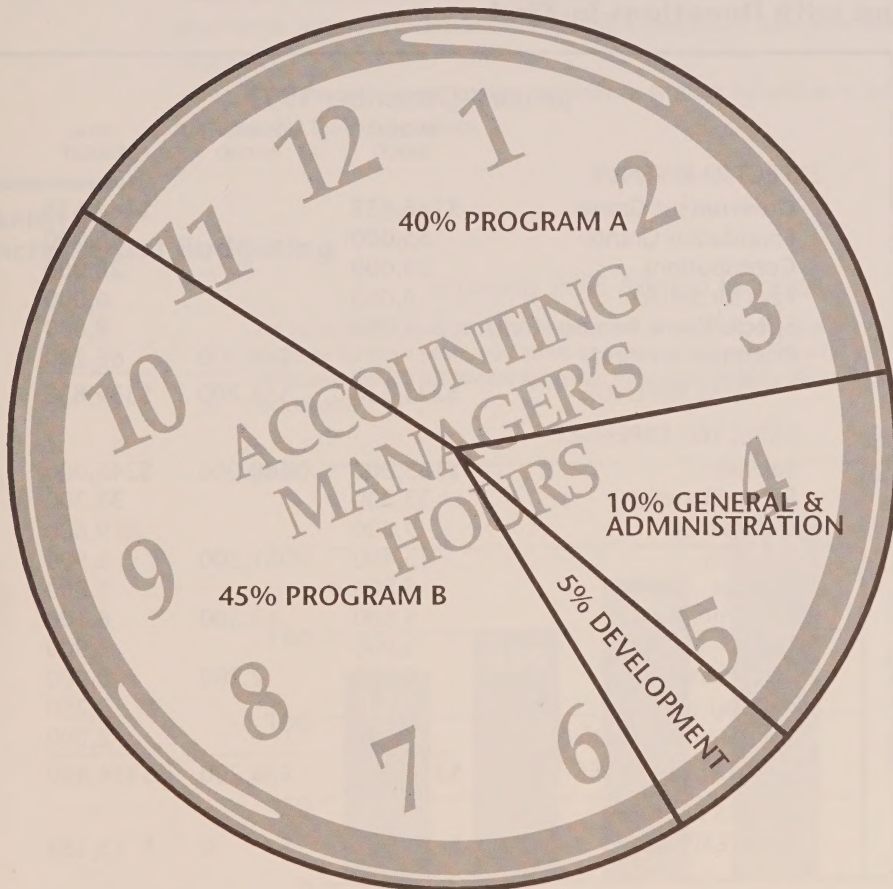
	January–December 1991					ALL OTHER SOURCES UNDER \$2,000
	TOTAL	FED. GRANT	CITY X	STATE	FDN Z	
EXPECTED REVENUE:						
Government Grants	\$166,638	\$106,897	\$ 19,907	\$ 39,834		
Foundation Grants	65,000				\$ 25,123	\$ 39,877
Contributions	28,000					28,000
Fees for Service	6,000					6,000
Special Event Revenue (net)	8,000					8,000
TOTAL REVENUE:	\$273,638	\$106,897	\$ 19,907	\$ 39,834	\$ 25,123	\$ 81,877
EXPECTED EXPENSES:						
Salaries	\$185,000	\$ 64,073	\$ 15,000	\$ 30,000	\$ 15,927	\$ 60,000
Fringe/Benefits	33,300	11,533	2,600	5,400	2,867	10,900
Occupancy	9,600					9,600
Supplies	5,400	3,000				2,400
Postage	3,250	1,450				1,800
Equipment	5,800	2,525				3,275
Travel	3,600	1,375			500	1,725
Telephone	3,900	1,200		750		1,950
Printing	6,200	2,900		150	1,900	1,250
Staff Training/Conferences	2,200	1,025		250		925
TOTAL EXPENSES	\$258,250	\$ 89,081	\$ 17,600	\$ 36,550	\$ 21,194	\$ 93,825
Share of Indirect Costs		\$ 17,816	\$ 3,520	\$ 7,310	\$ 4,239	\$(32,885)
TOTAL EXPENSES AFTER INDIRECT COST	\$258,250	\$106,897	\$ 21,120	\$ 43,860	\$ 25,433	\$ 60,940
Excess (Deficit) Revenue Over Expenses	\$ 15,388	\$ 0	\$ (1,213)	\$ (4,026)	\$ (310)	\$ 20,937

Time Budgets

Since a major expense of most nonprofits is personnel, it is often helpful from both a planning and monitoring point of view to develop a time budget. This type of budget breaks out expected personnel hours, which can be then used to estimate personnel expenses for each program.

A person working a 40 hour work-week with 2 weeks vacation, 2 weeks health leave and 10 paid holidays has 1840 hours available if working full-time without overtime. A person working a 35 hour work-week with the same vacation, health leave and holidays has 1620 hours available.

If a time budget is monitored periodically along with the dollar budget, more information will be provided regarding the nature of budget variances. Finally, if preparing and monitoring time budgets are part of the organization's budget process, a valuable pool of data will be developed over time regarding the personnel resources necessary to perform various activities.



Donations-In-Kind Budgets

Many nonprofit organizations depend on donations of goods, services, volunteer time and equipment to support their programs. A regular budget usually does not reflect those donations-in-kind. In order to more accurately reflect the true cost of running a program and to indicate the support given to the organization in forms other than cash, an organization may develop a budget that includes the value of donations-in-kind (Exhibit 7). The goods, services and equipment are listed at their fair market value, while volunteer time is normally valued at what the organization would pay the volunteers if they were paid staff of the organization. The total amount of donations-in-kind is listed as a line item under revenue, while each donations-in-kind line item is listed in the appropriate category under expenses. By doing so, the donation-in-kind revenue and expense items do not indicate result in either a net income or net loss, but the organization has a clearer sense of the cost of operating a program and the support it receives in a form other than dollar contributions.

EXHIBIT 7

Sample Budget with Donations-In-Kind

January–December 1991			
	REGULAR BUDGET	DONATIONS- IN-KIND	TOTAL BUDGET
EXPECTED REVENUE:			
Government Grants	\$166,638		\$166,638
Foundation Grants	65,000		65,000
Contributions	28,000		28,000
Fees for Service	6,000		6,000
Special Event Revenue (net)	8,000		8,000
Donations-in-Kind		\$66,200	66,200
TOTAL REVENUE:	\$273,638	\$66,200	\$339,838
EXPECTED EXPENSES:			
Salaries	\$185,000	\$60,000	\$245,000
Fringe/Benefits	33,300		33,300
Occupancy	9,600		9,600
Supplies	5,400	1,500	6,900
Postage	5,800		5,800
Equipment	3,600	2,500	6,100
Travel	3,900		3,900
Telephone	6,200	2,200	8,400
Printing	3,250		3,250
Staff Training/Conferences	2,200		2,200
TOTAL EXPENSES	\$258,250	\$66,200	\$324,450
EXCESS REVENUE OVER EXPENSES	\$ 15,388	\$ 0	\$ 15,388

Estimating Expenses

Estimating expenses for new projects or programs can be difficult for service organizations. In addition, agency-wide budgets may be difficult because those budgets must fit together several different programs. This task is made even more difficult when it is impossible to know in advance the funding level of various programs.

Incremental Budgeting

Incremental budgeting is the traditional approach to budget preparation in human service agencies. In this method, each line item is changed by a fixed percentage. For example, each expense line item may be increased by 10%, or perhaps cut by 8% to allow for inflation or budget cuts. This process doesn't encourage examination of operational experience or permit innovation. Although incremental budgeting is simple and takes little time, it may not be very helpful.

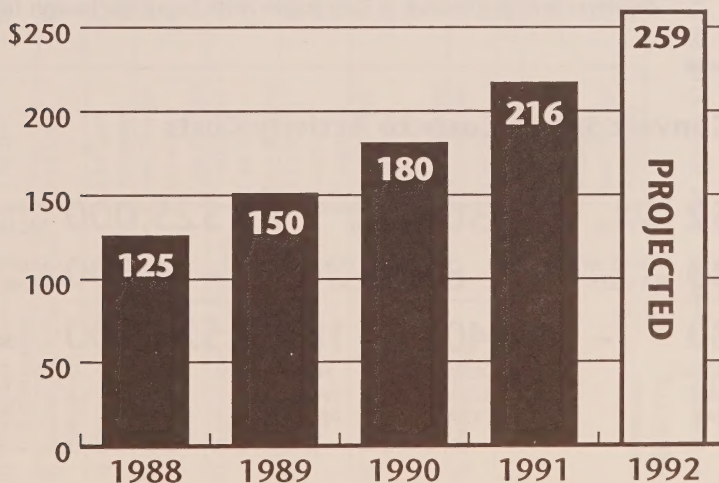
The previous year's budget experience is most helpful as a guide rather than as a substitute for budget decisions.

EXHIBIT 8

Incremental Budgeting

Showing 20% Annual Increase

An incremental budget follows this type of analysis. By looking at the rate of increase for prior years, you arrive at a rate to estimate the next year's increase. Although this is a traditional approach to budget making, more detailed analysis is advisable.



Developing a Program Activity Budget

Below is one method of making a realistic estimate of the cost of a program, especially when costing a new program. See Exhibit 10 for a sample, filled in, Program Activity Budget.

To fill in the Program Activity Budget Worksheet, begin by listing in order all the activities or tasks required. Determine how much time it will take to complete each task and assign each task to a specific staff position. The following method can be used to convert salary costs into activity costs:

1. Add the annual salary and employer's payroll tax expense for the staff person. Add the cost of fringe benefits such as health insurance, state unemployment insurance, workers' compensation insurance, etc.

\$25,000 salary

+ estimated (18%) \$4,500 for employer share of payroll tax expense and fringe benefits
= \$29,500

2. Compute total hours of vacation, holidays and sick leave. Subtract from total hours available to get hours worked per year.

Vacation of 10 days, 10 holidays, and 10 days sick leave = 30 days off per year;
at 40 hours/week this is 240 hours leave per year.

Total hours available 2080 (52 weeks x 40 hours)

- 240 leave hours

= 1840 hours of work per year.

3. Divide the number of work hours per year into the total compensation costs to obtain the hourly cost.

\$29,500 ÷ 1840 hours = \$16.03/hour (including all benefit costs).

After estimating the salary costs involved, identify all other directly related costs, such as supplies, travel, printing, etc. Don't forget hidden costs such as the time to seek select and train new staff. The program's fair share of indirect costs (also called shared costs) should be added to calculate the total cost of the program. (See the section "Indirect Costs".)

Projecting activities, time requirements, staff assignments, and costs will help you develop a realistic budget. A time frame helps break the budget into monthly increments to

EXHIBIT 9

How to Convert Salary Costs to Activity Costs

52 WEEKS PER YEAR × 40 HOURS AVAIL. PER WEEK 2080 TOTAL HOURS AVAILABLE PER YEAR	30 DAYS LEAVE PER YEAR × 8 HOURS PER WORK DAY 240 HOURS OF LEAVE PER YEAR	30 DAYS LEAVE PER YEAR × 8 HOURS PER WORK DAY 240 HOURS OF LEAVE PER YEAR	1840 HOURS WORKED PER YEAR	\$25,000 ANNUAL SALARY + 4,500 EMPLOYER SHARE OF BENEFITS, EST. AT 18% \$29,500	= \$16.03 HOURLY COST OF EMPLOYEE WITH \$25,000 ANNUAL SALARY
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Program Activity Budget

EDUCATION PROGRAM BUDGET

Prepared by: J. Kaye

Date Prepared: November 1990

Program Objective: Increase awareness of AIDS and educate about safer sex.

TASK/ACTIVITY	PERSON RESPONSIBLE	STAFF TIME	SALARY & FRINGE	SUPPLIES	PRINTING	POSTAGE	OTHER DIRECT COSTS TRAVEL	EQUIPM	PHONE	TRAINING	TOTAL COSTS
1) Develop and distribute educ. and PR materials	Proj Director	300	5,772		4,800	1,450					13,625
	2 Ed Spec	100	1,603								
2) Workplace training at 100 companies	2 Ed Spec	600	9,620	1,000			525	875			12,020
3) Training in 100+ school classrooms	2 Ed Spec	800	12,826	1,000			425				14,251
4) Education program for commty. groups & public	2 Ed Spec	216	3,463	1,000			475	500*			4,938
	Volunteers	200*	3,206*								
5) Admin. and PR for program	Proj Director	225	4,329								
	Secretary	425	5,652					1,650	1,200		15,075
	Exec Director	100	2,244								
6) Supervision, evaluation, staff training/conference	Proj Director	96	1,847								
	2 Ed Spec	96	1,539								4,104
	Exec Director	32	718								
7) Schedule trainings, administration	2 Ed Spec	200	3,206				450			1,025	6,063
	Secretary	104	1,382								
	Volunteers	100*	1,603*								
8) Staff meetings, reports, misc.	Proj Director	300	5,772								
	2 Ed Spec	1,280	20,522								
	Secretary	113	1,502								
	Exec Director	50	1,123								
9) Networking	Proj Director	263	5,059								
	2 Ed Spec	388	6,221								
	Proj Director	5,688	94,400	3,000	4,800	1,450	1,875	2,525	1,200	1,025	110,275
	2 Ed Spec	1,184	22,779					500*			
	Secretary	3,680	59,000								
	Exec Director	642	8,536								
	Volunteers	182	4,085								
	Volunteers	300*	4,809*								
TOTAL DIRECT COSTS											22,055
20.0% SHARE OF INDIRECT COSTS											\$ 5,310 *
TOTAL ALL COSTS											\$ 132,330 +
TOTAL IN-KIND (per "a" amounts)											\$ 5,310 *

BENEFITS

- **Revenue Benefits:** Govt. grants \$106,897 • Foundation grants \$25,123 • Fees \$1,000
- **Direct Service Benefits:** At least 100 classrooms (avg. 30/class); 100 businesses (avg. 225/business); at least 175 speaking engagements
- **Intangible Benefits:** Reduce spread of AIDS; more informed public

TOTAL BENEFITS SUMMARY: low medium high

COMMENTS: (Assumptions, risks, other considerations, organizational capabilities)

- Need to hire one more educ. specialist to start Jan. 1991; assumes federal grant will be renewed.

predict monthly cash needs. By listing staff assigned to each activity, you can coordinate responsibilities and determine staff work loads.

There are considerations other than cost when deciding whether to take on the program.

After determining costs, identify the amount and source(s) of revenue benefits, if any, associated with the objective. Use this revenue information, along with data regarding direct service benefits and intangible benefits accrued, to do some cost/benefit analysis. You may also wish to include a feasibility assessment of the program, such as looking at the assumptions, risks, and other considerations, before deciding to undertake it.

To determine a program's feasibility, cost analysis should include identifying the amount and source(s) of revenue benefits (if any) associated with the program's objective.

Cost Per Service Unit

Two measures are commonly used: total cost per service unit and net cost per service unit. Total cost per service unit may yield numbers such as \$170 per client appointment or \$5,500 per client per year. In either example, first choose a unit of service appropriate to your work and the way costs are assigned. For a medical clinic, this may be cost/intake appointment or cost per client per year. An I&R program may choose to calculate total costs/telephone referral. Calculations of total cost per service unit are not useful for comparing different kinds of services. Instead, such calculations are useful when seeing what economies of scale result from different service levels (see below).

In contrast, net costs/service unit provide the agency with one measure (certainly not the only measure) for comparing the agency's priorities with its use of unrestricted dollars. Net costs/unit take into account the revenue a program generates. For example, a government contract program may result in \$0 net costs/service unit because the government funds cover the total costs of the program. If one program results in \$500 net costs/unit, the agency may consider whether this subsidy from its unrestricted funds is in line with its priorities.

Budgeting for Different Levels of Activity

Organizations may find it helpful to calculate the costs of operating a program at different levels of activity. Not one, but two (or more) budgets can be developed. The first assumes that the program will be cut back to provide the minimum level of service to which the organization is irrevocably committed; this becomes the base cost. The second level assumes additional service with corresponding additional costs.

The assumption is often made that increasing the level of activity results in decreasing the total cost/service unit. Costing programs at different levels can reveal the level with maximum economies of scale; this level may actually be lower than expected.

Forecasting Revenues & Contingency Budgeting

In the for-profit sector, forecasting techniques are used, for example, to predict sales income, cost of parts and materials, investment performance, and the effects of capital purchases. In the nonprofit sector, forecasting is usually used to project revenue, such as sales or fees. Forecasting techniques can also be used to predict the number of hospital admissions, enrollment in various college classes, etc.

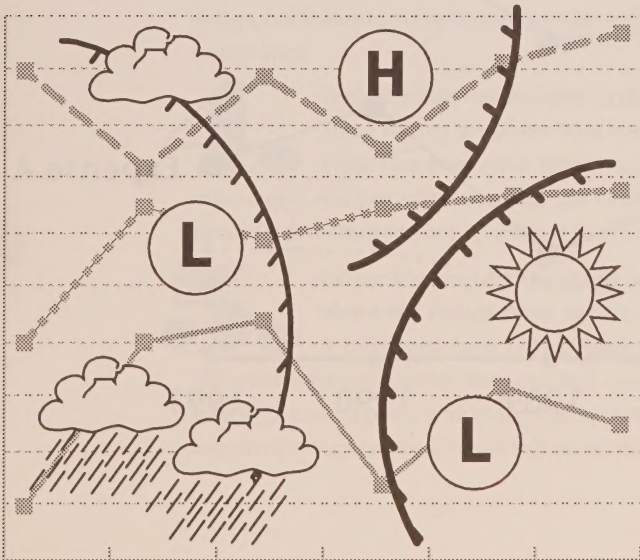
When estimating revenues, many people simply use intuitive judgment and make an educated guess. Sometimes the educated guess is made by a group or is based on the opinions of several informed people.

For small or new organizations, and for simple decisions in all kinds of organizations, making an educated guess may be the best forecasting method. More formal forecasting involves applying statistical and mathematical techniques to historical data to make projections for the future.

All forecasting and predicting—from “seat of the pants” to highly complex modeling—is based on the premise that future events can be predicted based on patterns discovered through reviewing historical information. This might seem obvious, but future events may not follow the patterns of the past.

The steps described below can help a group of people think through revenue projections in a more directed, systematic way.

Making an educated guess may be the best forecasting method for small or new organizations and for simple decisions in all kinds of organizations.



Continued

Steps In a Simplified Forecasting Process

1. Look at the figures from past years for a particular activity and see what jumps out.

By graphing results over 3-5 years, trends and important factors often leap out. In one year, for example, we might see a big jump in a type of revenue. This might remind us of an event or circumstance that year.

2. Make educated assumptions about the two or three key factors that influence the revenue from a certain activity.

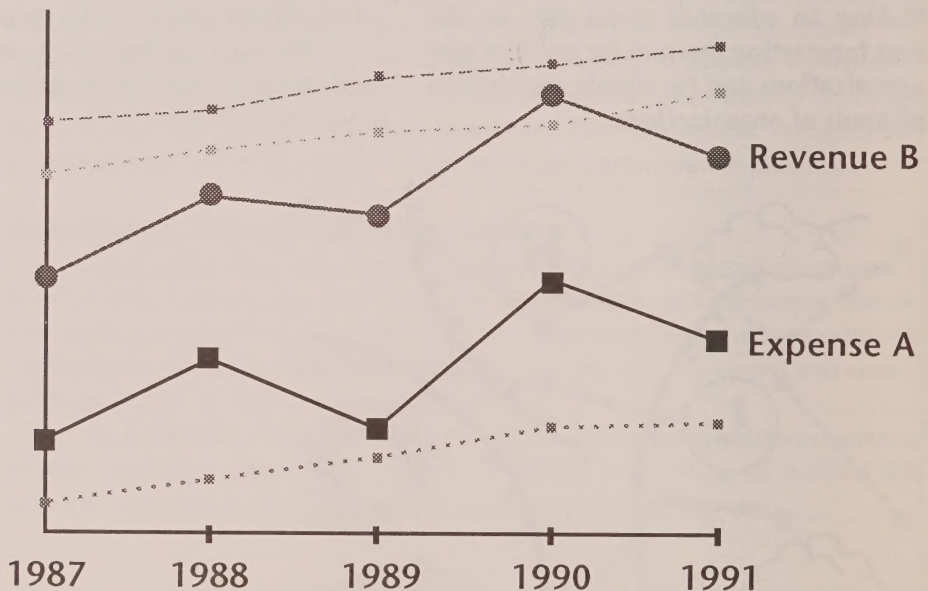
For example, when forecasting T-shirt sales, a list of influencing factors might include: amount of advertising purchased to promote the T-shirts, at how many community events the shirts will be sold, price of the shirts, shirt design, etc.

When forecasting fees from a job counseling program, factors might include: unemployment rate in the area, advertising to publicize the service, outreach to churches and community groups, fee rate, etc.

EXHIBIT 11

Five-Year Program Activity Graph

Graphing results over 3-5 years can reveal trends that can help in budget forecasting.



WHAT'S MORE IMPORTANT THAN GETTING BETTER AT GUESSING:

Forecasting revenue is not a substitute for meeting three other challenges:

1. Planning for uncertain revenue
2. Reducing risk
3. Developing quick feedback mechanisms

3.

Determine how those factors affected revenue.

Based on past experience, try to describe the relationship in measurable, quantifiable terms. For example, it might be possible to say that each community event at which T-shirts are sold results in sales of 60 T-shirts. Or that when advertising expense is doubled, T-shirt sales double as well. There may be patterns to uncover—for example, that sales go up and down on a three year cycle.

Determining these relationships obviously requires accurate information about past experience. Information over several years will probably result in better projections than information from a short period of time.

If several factors exist, it may be hard to sort out which factors are VERY important and which are unimportant. Simple charts or complex methods can be used to hypothesize these relationships. One important concern is the possibility of overlooking a critical factor entirely. For example, you may have thought that T-shirts sold well based on advertising and quality of design, but it may turn out that the average summer temperature each year was a factor of greater importance.

4.

Project what will happen to the key factors in the next few years.

Some factors are under your control, such as the amount spent on advertising. Predicting how other factors will behave may involve research, analysis of past experience, and just plain guessing. For example, if the local unemployment rate is a major factor in determining your revenue, it is necessary to hypothesize a rate for the coming year.

5.

Go back to the original graph and, based on past experience and suppositions about the future, draw up the forecast.

A forecasted *range* (rather than an exact number) may be all that is necessary. Different estimates can be discussed and compared. Often the comparisons will help clarify assumptions and plans underlying the forecasts. Don't be afraid to toss the whole thing out if experience suggests the forecast will be off for some real but hard-to-quantify reason.

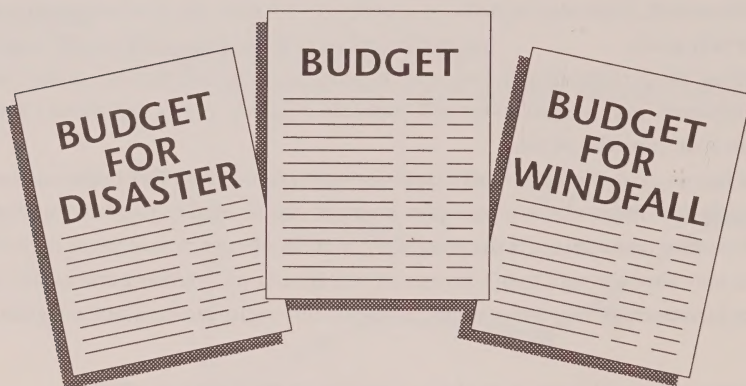
Continued

Contingency Planning

If an organization receives all its funding from two foundations, quantitative forecasting techniques are not appropriate. *Predicting* whether the two foundations will renew their grants may be less important than developing a flexible, adaptable plan that can be quickly modified once the foundations have decided. The organization may also choose to develop other revenue sources to decrease its dependency on these two foundations. Feedback systems that bring information quickly to decision-makers can permit adjustments to be made as the revenue picture develops.

Contingency planning entails drawing up alternative sets of plans that can be quickly adopted once the contingency (the possible event) occurs. In the above example, the agency might develop a budget in the event one of the foundations does not renew the grant ("planning for disaster") and another budget in case a third foundation decides to fund the agency ("planning for windfalls").

In addition to speed of transition, contingency planning allows decisions to be made calmly, without the urgency and emotionally charged atmosphere that may occur when a possible event comes to pass.



Budget Monitoring and Revision



Budget monitoring is an important element of an organization's control systems. Since the budget is a plan expressed in dollars, comparing budgeted to actual amounts helps staff see how closely the plans are being carried out. If there is a major variance, then management must decide whether the variance is a problem, analyze the causes for the variance, determine how the organization can get back on track, or make the appropriate budget revisions.

A budget is a guide, not a substitute, for decision making. Management must continuously assess the current financial condition as well as revise future plans for the organization.

To prepare a budget monitoring report, begin with the Statement of Revenue and Expense. Comparisons are made for both the current month and year-to-date amounts. Either percentage or dollar variances are noted, as well as the total budget for the year. When developing a budget monitoring report, staff should

not always simply take the "Budget for Year" amount and divide by 12 months. For certain fixed costs, such as rent, dividing by 12 might be appropriate. However, for other expenses such as

EXHIBIT 12

Budget to Actual Report for Control and Variance Analysis

Statement of Revenue & Expenses, and Comparison with Budget
for the Month of June and the six months ending June 30, 1991

MONTH OF JUNE 1991			YEAR TO DATE			BUDGET FOR YEAR	
Actual	Budget	+/- Variance	Actual	Budget	+/- Variance		
REVENUE							
\$12,818	\$12,818	\$ 0	Government Grants	\$ 74,634	\$ 74,634	\$ 0	\$166,638
14,000	4,000	10,000	Foundation Grants	31,500	21,500	10,000	65,000
1,000	1,500	- 500	Contributions	10,000	14,000	- 4,000	28,000
600	500	100	Fees For Service	3,600	2,600	1,000	6,000
4,500	3,000	1,500	Event Revenue (net)	4,500	5,000	-500	8,000
<u>\$32,918</u>	<u>\$21,818</u>	<u>\$11,100</u>	TOTAL REVENUE	<u>\$124,234</u>	<u>\$117,734</u>	<u>\$ 6,500</u>	<u>\$273,638</u>
EXPENSES							
\$15,417	\$15,417	\$0	Salaries	\$90,147	\$ 92,502	-\$ 2,355	\$185,000
2,600	2,775	- 175	Fringe Benefits	16,226	16,650	- 424	33,300
800	800	0	Occupancy	4,800	4,800	0	9,600
242	300	-58	Supplies	3,786	4,500	- 714	5,400
350	400	-50	Postage	2,700	2,550	150	5,800
150	125	25	Equipment	3,200	3,200	0	3,600
125	100	25	Travel	925	875	50	3,900
500	300	200	Telephone	3,000	2,600	400	6,200
300	275	25	Printing	2,300	2,525	- 225	3,250
1,000	225	775	Training/Conference	1,000	1,250	- 250	2,200
<u>\$21,484</u>	<u>\$20,717</u>	<u>\$ 767</u>	TOTAL EXPENSES	<u>\$128,084</u>	<u>\$131,452</u>	<u>(\$ 3,368)</u>	<u>\$258,250</u>
\$11,434	\$ 1,101	\$10,333	EXCESS (DEFICIENCY)	(\$ 3,850)	(\$ 13,718)	\$ 9,868	\$ 15,388

travel or equipment, the budget for a month should take the timing of the planned expense into consideration. The same holds true for revenue projections. For example, special event revenue should be budgeted for the months in which the events are scheduled. See Exhibit 12 for a sample Budget to Actual Report for Control and Variance Analysis.

Budget Revision

A budget is a guide, not a substitute, for decision-making. Management must continually be assessing the current financial condition of the organization as well as revising its future plans for the organization. For example, six months ago, when an agency prepared its budget, the organization might have projected \$20,000 in foundation grants. Now, six months later, only \$6,000 may have been received, but managers know now that the organization will receive \$22,000 in foundation grants by the end of the year. A revised budget would be developed to reflect the anticipated increase in revenue. The revised budget is based on the information available at the time the revision is made, rather than relying on outdated budget decisions that were made months ago. See Exhibit 13 for a sample worksheet of Budget Projections for Planning Purposes.

A budget revision can also be helpful if, at a certain period of time, the organization anticipates that its projected revenues will be considerably less than the initial budget indicates. Staff should revise the budget to reflect any necessary expense cuts that may be either anticipated or necessary. A revised budget helps the organization anticipate where it will stand at the end of the year, setting the stage for the next budget period.

EXHIBIT 13

Budget Projections for Planning

Revised Budget as of 6/30/91

	A ORIGINAL APPROVED BUDGET	B EXPENDED/ RECEIVED thru 6/30	%B of D	C STILL EXPECTED	D REVISED BUDGET	%D of A	EXPLANATION OF CHANGES
EXPECTED REVENUE							
Government Grants	\$166,638	\$74,634	45%	\$92,004	\$166,638	100%	
Foundation Grants	65,000	31,500	47%	35,000	66,500	102%	
Contributions	28,000	10,000	50%	10,000	20,000	71%	Recession affects contrib. levels
Fees For Service	6,000	3,600	50%	3,600	7,200	120%	Fees collect better than expected
Event Revenue (net)	8,000	4,500	47%	5,000	9,500	119%	1st event—more \$ than expected
TOTAL REVENUE	\$273,638	\$124,234		\$145,604	\$269,838	99%	
EXPECTED EXPENSES							
Salaries	\$185,000	\$90,147	49%	\$92,500	\$182,647	99%	Delay in hiring 2nd Educ. Spec.
Fringe Benefits	33,300	16,226	52%	14,800	31,026	93%	Same as above—savings in unemploy.
Occupancy	9,600	4,800	49%	5,040	9,840	102%	5% increase in rent
Supplies	5,400	3,786	68%	1,800	5,586	103%	
Postage	5,800	2,700	51%	2,600	5,300	91%	Mo. postage + 2 solicitations
Equipment	3,600	3,200	81%	750	3,950	110%	Maint. Agrmt. higher than expected
Travel	3,900	925	24%	2,950	3,875	99%	Travel to confrence sched. for Oct.
Telephone	6,200	3,000	50%	3,000	6,000	97%	
Printing	3,250	2,300	64%	1,300	3,600	111%	Printed two more solicitations
Training/Conference	2,200	1,000	45%	1,200	2,200	100%	
TOTAL EXPENSES	\$258,250	\$128,084		\$125,940	\$254,024	98%	
EXCESS (DEFICIENCY)	\$15,388	(\$3,850)		\$19,664	\$15,814	\$0	

The Accounting Equation: The Basis of Accounting

Double entry bookkeeping underlies all standard accounting and is based on centuries of development. Both double entry bookkeeping and accounting have their theoretical foundations in the Accounting Equation, on which the system of debits and credits is based. In turn, financial statements are the end result of the categorizing and balancing that occurs in the accounting system.

Learning rudimentary bookkeeping principles is a practical method of understanding financial statements.

Some directors who lack a formal financial background find it useful to learn rudimentary bookkeeping principles as a way of understanding financial statements. The following section briefly explains the development of the financial statements from the Accounting Equation.

All of accounting is based on an accounting equation that states:

$$\text{ASSETS} = \text{LIABILITIES} + \text{FUND BALANCE}$$

The left side of the equation lists what we have — these are known as ASSETS. The right side of the equation explains who owns those assets: if others own the assets they are called LIABILITIES; if we own the assets they are known as the FUND BALANCE (also called NET ASSETS).

Examples of ASSETS include cash in the bank, accounts receivable (IOU's from others), security deposits and prepaid expenses, pledges receivable, furniture and equipment, vehicles, stocks and bonds. (Some assets cannot be measured objectively in monetary terms, such as reputation for good work, or a helpful volunteer.)

LIABILITIES include what we owe to others, such as accounts payable (unpaid bills that have been expensed), payroll taxes payable, loans, mortgages, etc. Liabilities also include money we have received from a funder or a client, but that we have not yet earned, known as deferred or unearned revenue.

The difference between what we have (assets) and what we owe (liabilities) is what we are worth — our FUND BALANCE.

For example, if we have \$500 in the bank and of that \$500 we had borrowed \$200 from a friend, we could state our financial picture as follows:

what we have		what we owe		what we are worth
ASSETS	–	LIABILITIES	=	FUND BALANCE
\$500	–	\$200	=	\$300

The accounting equation (Assets = Liabilities + Fund Balance), the one that we use for recording financial transactions, is another way of stating Assets - Liabilities = Fund Balance. The accounting equation would state our financial picture as follows:

what we have		what we owe		what we are worth
ASSETS	=	LIABILITIES	+	FUND BALANCE
\$500	=	\$200	+	\$300

Financial statements use this latter equation, ($A = L + FB$) to represent an organization's financial status.

Another way of calculating the Fund Balance is to add up all the revenue the organization has earned and subtract all the expenses incurred for the year. That amount is then added (or subtracted if there is a deficit) to the prior year's Fund Balance to calculate the current Fund Balance.

EXAMPLE

Year 1: Revenue	\$5000	Year 2: Revenue	\$7000
Expenses	\$4000	Expenses	\$7700
Excess	\$1000	Excess (Deficiency)	(\$ 700)
Previous F.B.	\$ 0	Previous F.B.	\$1000
Current F.B.	\$1000	Current F.B.	\$ 300

Double Entry Bookkeeping

Bookkeeping is the recording of financial transactions. Double entry bookkeeping is a method of recording financial data that, when used correctly, ensures that the accounting equation is always in balance. All transactions should be recorded using a double entry system.

Using the accounting equation and the principles of double entry bookkeeping, we can record the following transactions:

1. Receive a grant for \$700
2. Pay \$200 to the telephone company
3. Pay \$100 to the printer
4. Charge \$300 in supplies at the stationary store

Arrows indicate whether accounts (assets, liabilities, or the fund balance) are increased or decreased.

EXAMPLE

ASSETS = LIABILITIES + FUND BALANCE		
	REVENUE Revenue increases the fund balance	EXPENSE Expenses decrease the fund balance
1. ↑ \$700 CHECKING	↑ \$700 GRANTS	
2. CHECKING ↓ \$200		↓ \$200 PHONE
3. CHECKING ↓ \$100		↓ \$100 PRINTER
4. A/P ↑ \$300		↓ \$300 SUPPLIES

In this example, double entry bookkeeping records whether you are increasing or decreasing an asset, liability or fund balance account while at the same time keeping the accounting equation balanced. It is worth noting that an increase of a revenue account increases the fund balance, while an *increase in an expense account decreases the fund balance*.

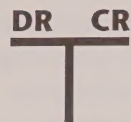
Arrows, however, would be an inefficient method for recording financial transactions. Therefore, accountants and bookkeepers uses debits and credits

Debits (DR) and credits (CR) record whether accounts (specific categories of assets, liabilities, fund balances, revenue, and expenses) are being increased or decreased. DEBITS and CREDITS often confuse non-accountants because they have different definitions in the language of accounting than they do in English: “debit” and “credit” are *not* synonymous with “decrease” or “increase.”

Debits and credits are further confusing because, depending on which side of the equation you are on, a debit will either increase or decrease an asset, liability, or fund balance account, and a credit will either increase or decrease an asset, liability, or fund balance account.

The most important thing to remember is that the accounting equation must always be balanced, that is to say, that an equal number of DR and CR have been recorded

Accounting personnel often refer to DR as an “entry made on the left side of an account,” and a CR as an “entry made of the right side of an account.” These accounting personnel are referring to entries that are ultimately made in a General Ledger (a ledger that has a summary of the organization’s financial transactions), in which two columns are used for recording the financial data: the DR will be on the left, and the CR will be on the right. For training or demonstration purposes this is often diagrammed as a “T account” (see illustration at left).



The chart below should help you understand what the bookkeeper does when keeping accounting books using the double entry bookkeeping method of recording financial transactions. Using a system of “T accounts,” the sample transactions noted above could be recorded as follows, using DR and CR to symbolize whether we are increasing an Asset, Liability, or Fund Balance Account:

Remember, “T accounts” are used to illustrate the concepts behind double entry bookkeeping. In reality, transactions are recorded in financial record books or journals, and then summarized in the General Ledger. See “Components of the Accounting System” for more information.

EXAMPLE

ASSETS

.....

DR	CR
INCREASES ASSETS ↑	DECREASES ASSETS ↓

LIABILITIES

.....

DR	CR
DECREASES LIABILITIES ↓	INCREASES LIABILITIES ↑

FUND BALANCE

.....

DR	CR
DECREASES REVENUES AND SO DECREASES FUND BALANCE ↓	INCREASES REVENUES AND SO INCREASES FUND BALANCE ↑

EXPENSES

.....

DR	CR
INCREASES EXPENSES AND SO DECREASES FUND BALANCE ↓	DECREASES EXPENSES AND SO INCREASES FUND BALANCE ↑

Checking

DR	CR
700	200 100

A/P

DR	CR
	300

REVENUE Grant

DR	CR
	700

EXPENSES Telephone

DR	CR
200	

Printing

DR	CR
100	

Supplies

DR	CR
300	

Financial Reports

Nonprofits prepare a variety of financial reports for internal and external use. Not all nonprofits need prepare all of the statements listed below.

Financial Statements

The two primary financial statements are the Balance Sheet and the Statement of Revenue, Expenses and Changes in Fund Balance (commonly known as the income statement). Other formal financial statements include the Statement of Net Cash Flows and the Statement of Functional Expenses.

- a) **Balance Sheet** summarizes the assets, liabilities, and fund balances (net assets) of the organization at a specified date. The Balance Sheet is a picture of the organization's financial position on that date. This statement is required on IRS Form 990. See Exhibit 14 for an example of a balance sheet.

BALANCE SHEET, DECEMBER 31, 1990

Assets		Liabilities + Fund Balance	
Checking	\$ XXXX	Accounts Payable	\$ XXXX
Savings	XXXX	Total liabilities	XXXX
Total assets	\$ XXXX	Fund Balance	XXXX
		Total liabilities + Fund balance	\$ XXXX

Assets are properties and resources the agency owns and can use to achieve its goals. *Current assets* include cash accounts, certificates of deposit, and items such as receivables which will be converted to cash within the year. *Fixed assets* include land, buildings, equipment, vehicles, and other non-current assets.

Liabilities are debts of the organization—what is owed. *Current liabilities* are due within one year and typically include accounts payable, short-term loans due, withheld payroll taxes due, etc. *Long term liabilities* include items such as long term debt or mortgages which will not be retired within the upcoming year.

Resources which are restricted for certain activities or programs are frequently reported under liabilities as “deferred revenue” or “contributions designated for future periods.” Once the restrictions have been met, these resources can be removed from liabilities and recognized as revenue.

Fund balance or net assets represent the difference between assets and liabilities, and is one way of measuring the net resources ultimately available to the organization. An organization's unrestricted fund balance shows the net resources available without restriction; restricted resources may be reflected as separate fund balances.

Continued

EXHIBIT 14

Balance Sheet

Minority Community-Based AIDS Organization Balance Sheet as of December 31, 1990

ASSETS

Cash	\$ 9,468
Grants Receivable	10,544
Prepaid Expenses	350
Current Assets	\$20,362
Fixed Assets (net of depreciation)	2,100
TOTAL ASSETS	\$22,462

LIABILITIES & FUND BALANCE

Accounts Payable	\$ 5,560
Accrued Expenses	1,478
Deferred Revenue	3,000
Current Liabilities	\$10,038
Fund Balance 1/1/90	\$10,081
Excess (Deficit) 1990	\$ 2,343
Fund Balance, 12/31/90	\$12,424
TOTAL LIABILITIES & FUND BALANCE	\$22,462

- b) **Statement of Revenue, Expenses and Changes in Fund Balance** reports the organization's financial activity over a period of time. It presents the types and amounts of revenue and expense, and the net revenue or difference between revenue and expenses. This statement is also called the Financial Activity Statement, the Statement of Revenue, Expenses and Changes in Net Assets, and the Income Statement. This statement is required on IRS Form 990. See Exhibit 15 for an example of an income statement.

Statement of Revenue, Expenses and Changes in Fund Balance

Minority Community-Based AIDS Organization Statement of Revenue and Expenses and Changes in Fund Balance For the Year Ending December 31, 1990

REVENUE

Government Grants	\$126,528
Foundation Grants	50,000
Contributions	19,685
Fees for Service	5,100
Special Event Revenue (net)	6,000
TOTAL REVENUE	\$207,313

EXPENSES

Salaries	\$147,930
Fringe Benefits	26,627
Occupancy	9,360
Supplies	3,400
Postage	4,500
Equipment	800
Travel	2,665
Telephone	5,692
Printing	2,795
Staff Training/Conferences	1,200
TOTAL EXPENSES	\$204,969
EXCESS REVENUES OVER EXPENSES	\$2,344

Continued

STATEMENT OF REVENUE, EXPENSES AND CHANGES IN FUND BALANCE

January 1 – December 31, 1990

REVENUE	
Grants	\$ XXXX
Donations	XXXX
TOTAL REVENUE	XXXX
EXPENSES	
Salaries	XXXX
Supplies	XXXX
Rent	XXXX
Telephone	XXXX
TOTAL EXPENSES	XXXX
Net	\$ XXXX
Previous fund balance	\$ XXXX
Current fund balance	\$ XXXX

- c) **Statement of Net Cash Flows** summarizes the resources that became available to the organization during the reporting period and the uses made of such resources. In addition to changes in resources because of revenue and expense, the Statement of Net Cash Flows (also called the Statement of Changes in Financial Position) shows changes in assets and liabilities that resulted from capital purchases and sales, investment activity, changes in deferred revenue, and acquiring or retiring debt. Smaller nonprofits can often show this information in the footnotes to the financial statements and may not need to prepare this statement.

SOURCES AND USES OF NET WORKING CAPITAL

January 1 - December 31, 1989

Sources	
New debt	\$ XXXX
Net income	XXXX
Depreciation	XXXX
Uses	
Invested in fixed assets	XXXX
Net loss	XXXX
Increase in net working capital	XXXX

- d) **Statement of Functional Expenses** reports all expenses as related either to program services or to supporting services. Expenses under program services are shown divided among the various programs. Expenses under supporting services are divided between management and general expenses on one hand, and fundraising expenses on the other. This statement is required on IRS Form 990.

STATEMENT OF FUNCTIONAL EXPENSES

January 1 - December 31, 1990

	Program	Mgt & General	Fundraising	Total
Salaries	\$ XXXX	\$ XXXX	\$ XXXX	\$ XXXX
Rent	XXXX	XXXX	XXXX	XXXX
Supplies	XXXX	XXXX	XXXX	XXXX
Total	<u>\$ XXXX</u>	<u>\$ XXXX</u>	<u>\$ XXXX</u>	<u>\$ XXXX</u>

Other key financial reports for nonprofit organizations include:

- **Government information returns:** Nonprofit organizations are required by federal and state governments to file various reports to maintain their tax-exempt status and document tax compliance. The primary federal reports are the annual Form 990 and Schedule A to the 990. State governments may require additional reports.
- **Tax reports:** Payroll tax reports are required by federal and state agencies, and by some cities as well. Organizations also must report taxable income from business activity unrelated to their tax-exempt purposes (unrelated business income). If an organization engages in sales, state sales tax regulations are applicable.
- **Reports to funders** are based on the terms of the grants. In some cases, periodic statements report to the funder the ways grant funds were spent. Another report to a funder is a "reimbursement request" in which the funder is billed for the amount spent by the organization on a program established through a contract arrangement. Some reports to funders focus almost exclusively on program output such as numbers of clients served, and may report only the agency's consolidated financial activity.
- **Management reports** are for internal use by the organization. They are selected and formatted to answer specific concerns of management. Some examples of financial reports for management:
- **Budget monitoring report:** reports actual revenues and expenses against budgeted amounts.
- **Cash flow report:** shows cash receipts and disbursements against anticipated flows.
- **Analysis of statements:** interprets financial statements in specific ways, such as showing trends in revenue diversity, etc.
- **Investment report:** shows performance of each investment, the composition of the portfolio, and other reports related to invested funds.

GENERAL QUESTIONS

How much cash do we have?

Are we living within our means?

Are revenue and expenses occurring as planned?

What is our basic financial health?

statement

How do we look for the rest of the year?

FINANCIAL REPORTS

Balance Sheet

Income statement

Actual vs. budgeted

Balance sheet, income

Revised budget, revised cash budget

From Double Entry Bookkeeping to the Preparation of Financial Statements

The end result of the accounting process is the production of the two primary financial statements: the Balance Sheet and the Statement of Revenue and Expenses and Changes in Fund Balance (also known as the Income Statement).

The bookkeeper uses the double entry bookkeeping process to record financial transactions in the Cash Disbursement Journal, Cash Receipts Journal, General Journal, and General Ledger. (See "Components of the Accounting System" for a further explanation of these books and a diagram of the entire accounting process from writing of checks and making deposits to preparing financial reports.) The debit and credit entries enable the bookkeeper then to produce the financial statements.

Exhibit 16 shows the relationship of double-entry bookkeeping to the preparation of financial statements. In Exhibit 16, a new organization starts to keep books on October 1, 1990.

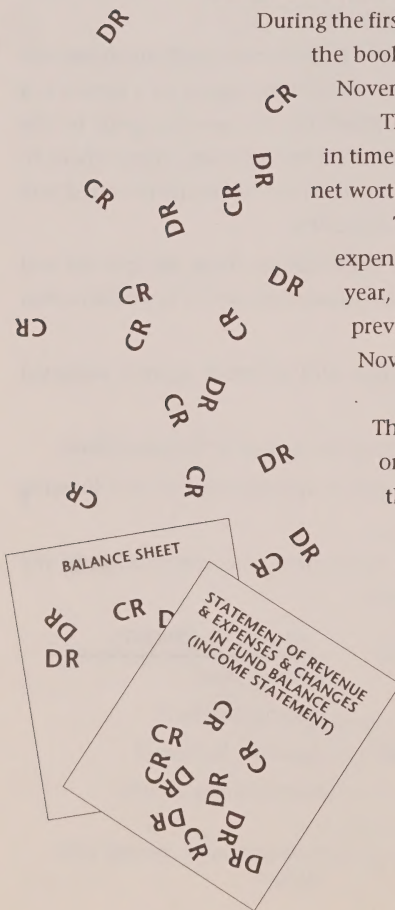
During the first two months, one deposit is received and two checks written. At that point, the bookkeeper can prepare the two financial statements for the period ending November 30, 1990.

The Balance Sheet gives a financial picture of the organization at a given point in time: the organization has a total of \$200 assets, and of those \$200 represent the net worth of the organization — the fund balance.

The Statement of Revenue and Expenses summarizes the total revenue and expenses that the organization has received to date from the beginning of the fiscal year, as well as the net (excess or deficiency of revenue over expenses) and the previous fund balance. The excess of revenue over expenses for the October 1–November 30 Statement of Revenue and Expenses is \$200.

Since this is a new organization there is no prior year fund balance. Therefore, the current fund balance is \$200. The current fund balance as listed on the Statement of Revenue and Expenses always equals the fund balance on the Balance Sheet.

In the next month, the organization receives fees, charges supplies at a local office supply company, and writes two checks. A Balance Sheet and a Statement of Revenue and Expenses for the period ending December 31, 1990 is then produced. The December 31, 1990 Balance Sheet shows that the organization has \$1850 of assets. Of those assets, \$300 is owed to others and the net worth — fund balance — of the organization is \$1550. The excess of revenue over expenses for the October 1–December 31 Statement of Revenue and Expenses is \$1550 and the current fund balance is \$1550.



Double-Entry Bookkeeping and the Preparation of Financial Statements

ASSETS = LIABILITIES + FUND BALANCE

REVENUE – EXPENSE

INCREASES THE
FUND BALANCEDECREASES THE
FUND BALANCE

1) DR \$500 CHECKING

GRANTS CR \$500 ←

1) October 1, 1990—
Receive grant for \$500
+ \$500 Checking;
+ \$500 Grants

2) CR \$200 CHECKING

DR \$200 PHONE ←

2) October 31, 1990—
Write \$200 check for phone
– \$200 Telephone;
– \$200 Checking

3) CR \$100 CHECKING

DR \$100 PRINTING ←

3) November 30, 1990—
Write \$100 check for printing
– \$100 Printing;
– \$100 Checking

Prepare BALANCE SHEET
for November 30, 1990
and a STATEMENT OF
REVENUE & EXPENSES
FOR TWO MONTHS,
October 1 –
November 30, 1990.

BALANCE SHEET November 30, 1990	
ASSETS = LIABILITIES + FUND BALANCE	
\$200	0 \$200

STATEMENT OF REVENUE & EXPENSES October 1–November 30, 1990	
Revenue	\$500
Expenses	\$300
Excess	\$200
Prior Year F.B.	\$ 0
Current F.B.	\$200

4) DR \$2,000 CHECKING

FEES CR \$2,000 ←

4) December 15, 1990—
Receive fees of \$2,000
+ \$2,000 Checking;
+ \$2,000 Fees

5) CR \$300 A/P

DR \$300 SUPPLIES ←

5) December 15, 1990—
Charge \$300 of supplies
– \$300 Supplies;
+ \$300 A/P

6) CR \$200 CHECKING

DC \$200 PHONE ←

6) December 31, 1990—
Write \$200 check for phone
– \$200 Telephone;
– \$200 Checking

7) CR \$150 CHECKING

DR \$150 PRINTING ←

7) December 31, 1990—
Write \$150 check for printing
– \$150 Printing;
– \$150 Checking

Prepare BALANCE SHEET
for December 31, 1990
and a STATEMENT OF
REVENUE & EXPENSES
FOR THREE MONTHS,
October 1 –
December 31, 1990.

BALANCE SHEET December 31, 1990	
ASSETS = LIABILITIES + FUND BALANCE	
\$1,850	\$300 \$1,550

STATEMENT OF REVENUE & EXPENSES October 1–December 31, 1990	
Revenue	\$2,500
Expenses	\$ 950
Excess	\$1,550
Prior Year F.B.	\$ 0
Current F.B.	\$1,550

Cash and Accrual Accounting

Cash and accrual accounting are two different methods of recording revenue and expenses in financial records.

CASH-BASIS ACCOUNTING

- Record revenue when the actual money is received
- Record expenses when bills are paid

ACCRUAL-BASIS ACCOUNTING

- Record revenue when earned (e.g., services are performed, terms of grant are met etc.)
- Record expenses when incurred (e.g., supplies are ordered, purchase order is written, etc.)

Cash-basis accounting is easier on a day-to-day basis, but not necessarily accurate. Accrual-basis accounting gives a more complete picture of the organization's finances, but is much more complicated.

Cash-basis accounting is easier on a day-to-day basis, but not necessarily accurate. Accrual-basis accounting gives a more complete picture of the organization's finances, but is much more complicated.

Exhibit 17 shows how preparing financial statements on an accrual basis will give a much more accurate and complete picture of an organization's financial condition:

As of December 31, 1991, the following accrual entries had not been made on the cash method of accounting financial statements:

- 1) \$5,000 of the grant money received to date was restricted for a program to take place in February, 1991.
- 2) \$2,000 in fees had been earned, but not yet paid.
- 3) \$3,000 in printing had been charged to the organization's account.

On a cash basis, it appears that the organization made a profit of \$5,000 and its current fund balance (net assets) is \$7,500. On an accrual basis, the financial statements look very different. The following accrual entries were made:

- 1) The \$5,000 restricted grant is removed from earned revenue and transferred to a liability account called "deferred (or "unearned") revenue."
- 2) The \$2,000 in earned fees are recorded as earned revenue, and listed as an asset account called "accounts receivable."
- 3) The \$4,000 printing bill, incurred during the 1990 fiscal year, is listed as an expense called "printing" and recorded as a liability called "accounts payable."

On an accrual basis, the financial statements show that the organization had a deficit \$2,000 during the year, and its fund balance is really \$500! If you were the executive director of this organization, which set of financial statements would help you make better financial management decisions?

Continued

Cash vs. Accrual Accounting

CASH BASIS	
BALANCE SHEET	
December 31, 1990	
ASSETS:	
Checking	\$ 7,500
A/R	0
Total Assets	<u>\$ 7,500</u>
LIABILITIES + FB	
LIABILITIES	
Accounts Payable	\$ 0
Deferred Revenue	0
Total Liabilities	<u>\$ 0</u>
Current Fund Balance	<u>\$7,500</u>
Total Liabilities & F.B.	<u>\$7,500</u>

ACCRUAL BASIS	
BALANCE SHEET	
December 31, 1990	
ASSETS:	
Checking	\$ 7,500
A/R	2,000
Total Assets	<u>\$ 9,500</u>
LIABILITIES + FB	
LIABILITIES	
Accounts Payable	\$ 4,000
Deferred Revenue	5,000
Total Liabilities	<u>\$ 9,000</u>
Current Fund Balance	<u>\$ 500</u>
Total Liabilities & F.B.	<u>\$9,500</u>

CASH BASIS	
STATEMENT OF REVENUE, EXPENSES AND	
CHANGES IN FUND BALANCE	
January 1 – December 31, 1990	
REVENUE	
Grants	\$15,000
Contributions	5,000
Fees	1,000
TOTAL REVENUE	<u>\$21,000</u>
EXPENSES	
Salaries	\$12,000
Rent	3,000
Printing	1,000
TOTAL EXPENSES	<u>\$16,000</u>
Excess (Deficiency)	\$ 5,000
Previous F.B.	\$ 2,500
Current F.B.	<u>\$ 7,500</u>

ACCRUAL BASIS	
STATEMENT OF REVENUE, EXPENSES AND	
CHANGES IN FUND BALANCE	
January 1 – December 31, 1990	
REVENUE	
Grants	\$10,000
Contributions	5,000
Fees	3,000
TOTAL REVENUE	<u>\$18,000</u>
EXPENSES	
Salaries	\$12,000
Rent	3,000
Printing	5,000
TOTAL EXPENSES	<u>\$20,000</u>
Excess (Deficiency)	\$ (2,000)
Previous F.B.	\$ 2,500
Current F.B.	<u>\$ 500</u>

Modified Cash or Modified Accrual Basis

An organization may also choose to keep their books on a modified cash or a modified accrual basis. Modified cash and modified accrual accounting are methods that strike a balance between the ease of cash-basis accounting and the accuracy of accrual-basis accounting. The elements of that balance may include the following:

- a) Recording small transactions (say, under \$100) on a cash basis, but larger transactions and withheld payroll taxes on an accrual basis.
- b) Recording income on a cash basis and expenses on an accrual basis. (Since receivables can fail to materialize, but payables are certain, this modified cash basis can be useful for producing conservative cash projections.)
- c) Keeping the books on a cash basis and preparing reports on an accrual basis. This can be accomplished by making accrual adjustments on a worksheet, without formally charging the accounting records. In another method, books are maintained on a cash basis, with appropriate accrual entries made at the end and beginning of the month.

Many small to medium-sized nonprofits use a cash or modified cash basis during the year because cash basis accounting is more easily handled by someone with little bookkeeping background. And, for many small nonprofits with few or no payables or receivables, there may be little meaningful difference between cash and accrual systems.

For auditing purposes, however, end of year financial reports *must* be prepared on an accrual basis.

Analyzing Your Accounting System

When revising your accounting system (or developing a new one) you should make sure it conforms to Generally Accepted Accounting Principles (GAAP) and is appropriate to your needs and resources. It should be flexible enough to adapt to programmatic changes and organizational growth. An effective accounting system has the following characteristics:

Information: The accounting system should be capable of generating reports that can be used for both internal and external purposes. *Internally*, the system should be capable of producing accurate, up-to-date information that will allow management to make financial and programmatic decisions. *Externally*, the accounting system should be able to readily provide information for funding sources, individual and corporate contributors, government agencies, professional societies and organizations, and the general public.

Reasonable period of time: The accounting system should be able to produce all the financial information you need in a reasonable period of time. End of month financial reports should be available no later than two to three weeks after the close of the month; end of year financial reports should be available no later than three to six weeks after the close of the fiscal year.

Documentation: The accounting system should be able to generate documentation required by funding sources, government and others.

Integration: The accounting system should provide an integrated view of financial activity in all programs and funds, as well as for the entire organization.

Sense: The accounting system should make sense to non-experts as well as to your financial staff.

Internal control: The accounting system should safeguard against embezzlement by separating the authorization, execution and approval of financial transactions.

Meet special needs: The accounting system should be responsive to special contract requirements that dictate how your records are kept.

Components of the Accounting System

Several important components are standard in a sound accounting system, including:

Chart of Accounts—a table of contents to the accounting system, containing a numerical list of all accounts.

Checkbook—where receipts are deposited and from which disbursements are made.

Cash Disbursement Journal—a chronological record of the checks that are written, categorizing each based on the Chart of Accounts.

Cash Receipts Journal—a chronological record of all the deposits that are made, categorized based on the Chart of Accounts.

General Journal—records non-cash transactions such as depreciation, error correction.

General Ledger—a consolidation of all the journal information (above) by summarizing each category of transaction and maintaining a year-to-date record for each account.

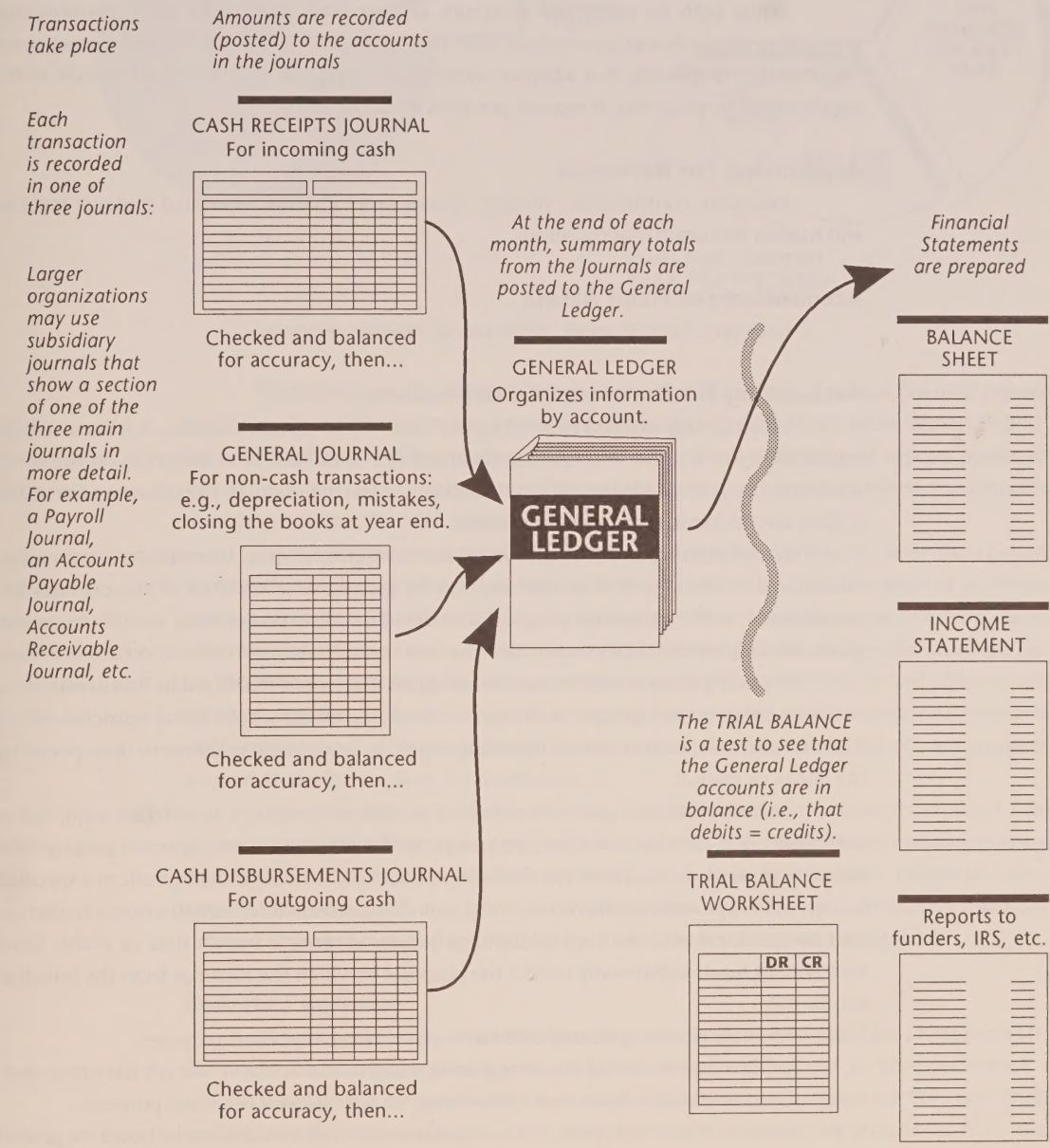
Trial Balance—a list and balance of the account totals from the General Ledger, testing to see whether the debits and credits are in balance.

Other components are useful depending on the size of your organization. A **Payroll Ledger** may be useful if your payroll is too large to be handled reasonably by your Cash Disbursement Journal.

Employee Payroll Earnings Summaries are individual records for each employee which keep records for the quarterly and annual payroll tax returns and for the annual W-2s. An **Equipment Ledger** is used to keep track of equipment and furniture and its depreciation. If your accounting system is kept on an accrual basis, other elements may include an **Accounts Receivable Journal** and **Accounts Payable Journal**.

Exhibit 18 diagrams the entire accounting process from writing of checks and making deposits to preparing financial reports.

The Accounting Process: From Transaction to Financial Statements



Accounting for Restricted Monies

While both for-profit and nonprofit organizations use double entry bookkeeping, accounting standards and conventions differ in several important ways. A critical management responsibility is ensuring that adequate expertise in nonprofit accounting is available to the organization. In particular, nonprofit practices are different in:

Accounting for Revenues

Examples: contributions, pledges, special event revenue, unrelated business income, and in-kind (non-cash) contributions

Accounting for Fixed Assets

Examples: capitalization, depreciation, expense methods

Accounting for Restricted Contributions

When an organization receives a grant restricted to certain activities, it takes on a legal responsibility to use that money only for those activities. Reference materials on nonprofit accounting are included in the "Further Reading" section this manual. The following discussion focuses on accounting for restricted monies.

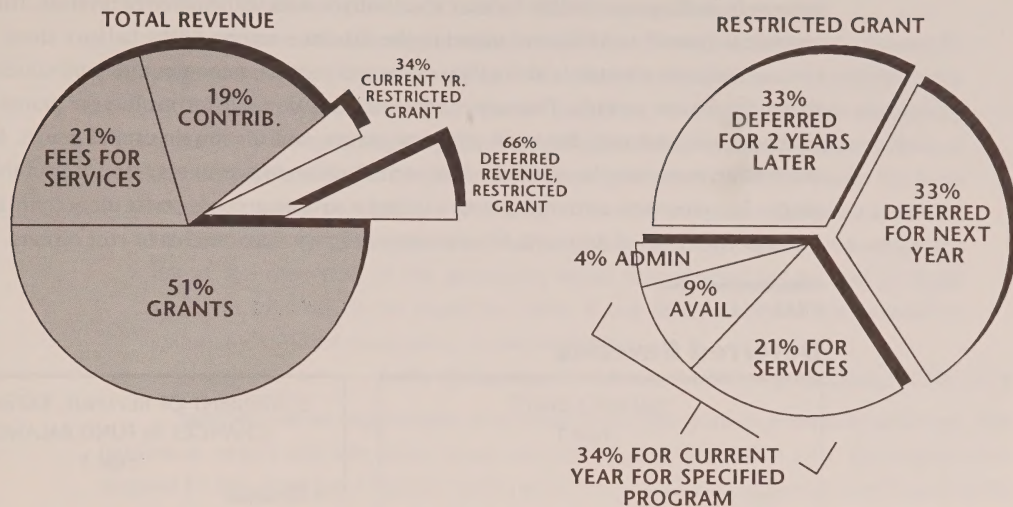
Nonprofits receive both unrestricted and restricted revenue. **Unrestricted revenue** has no external restrictions as to its use and can be used for any activities of the organization consistent with its tax-exempt purpose. **Restricted revenue** comes from contributions and grants which have been restricted by the donor or funder to be used only for certain activities.

For example, a foundation may award a grant that is restricted to public health education or a donor may make a gift that is restricted to building construction. Using restricted dollars for other purposes, such as general operating expenses, would violate the restrictions placed by the donor or grantor.

Contributions and grants are restricted for different purposes, in different ways, and to varying degrees. Gifts may be restricted to a particular purpose or to a particular geographical location. In some cases, grants may resemble contracts, restricting the nonprofit to a specified activity or to approved amounts for each line item. Endowment funds carry the donor restriction that the principal must be kept intact in perpetuity or until a certain date or event. Some endowment funds additionally restrict the purposes to which the earnings from the principal can be put.

Accurate reporting of restricted funds serves three important purposes:

- To demonstrate to the donor or grantor that the conditions of the gift have been met.
- To enable staff to keep track of how much is available for restricted purposes.
- To show that all resources of the organization are not available to the board for general purposes.



Frequently, an organization's auditor develops the necessary **external** financial reports based on rules established by the American Institute for Certified Public Accountants (AICPA). Such AICPA formats may not, however, be the best choice for **internal** reports produced throughout the year for management. The proper handling and reporting of restricted monies must be considered for both interim, internal reports, and for the audit.

Accounting for restricted monies received and expended within the same fiscal period is relatively simple. For example, an organization has received a foundation grant of \$5,000 to put on a conference. In a simple, manual bookkeeping system, the organization can simply keep a list of all conference-related expenses on a separate piece of paper or mark conference expenses on the journals. More formally, expense accounts just for the conference can be added to the Chart of Accounts. If the grant and the associated expenses occur in the same fiscal year, it is simple to keep track of "how much is left" as the conference preparations proceed and to prepare a report to the funder after the conference.

Difficulties increase as the life of restricted monies extends beyond one fiscal period. Part of the problem is that "the accounting profession has not yet resolved the appropriate reporting treatment for these types of gifts" (Gross, Warshauer & Larkin). In practice, nonprofits use a combination of methods to account for restricted monies, perhaps most frequently using the deferred revenue (unearned income) approach and the fund accounting approach.

Deferred Revenue

Deferred revenue is a method of tracking contributions designated for a time period in the future or tracking grants and contracts for which the work has not yet been performed.

Imagine that an organization is awarded a \$10,000 two-year grant for 1991 and 1992, and receives the whole amount in 1991. Only \$5,000 can be considered income for 1991. The remaining \$5,000 is designated for 1992. During 1991, the organization will show \$5,000 as

income from the grant, and the balance sheet will show \$5,000 as deferred revenue. This deferred revenue is "owed" to 1992, and shows in the liabilities section of the balance sheet.

Deferred revenue is also called unearned income, or sometimes contributions designated for future periods. This same approach can be used for multi-year grants (that are otherwise unrestricted), for small gifts and grants, and for simple capital grants. Individual deferred accounts may be established for each situation to permit easy reporting of the separate grants. In some cases, accounting staff may find it advantageous to revise the accounting system through the Chart of Accounts to create new program departments or cost centers.

EXAMPLE

Deferred Revenue

BALANCE SHEET Year 1	
<u>Assets</u>	
Cash	\$10,000
A/R	
Investments	
Fixed assets (less depreciation)	
Total assets	<u>\$10,000</u>
<u>Liabilities & Fund Balance</u>	
Deferred revenue	\$ 5,000
Fund balance	5,000
Total liabilities \$ fund balance	<u>\$10,000</u>

STATEMENT OF REVENUE, EXPENSES & CHANGES IN FUND BALANCES Year 1	
<u>Revenue</u>	
Contributions	
Grants	\$ 5,000
Fees	
Total Revenue	<u>\$ 5,000</u>
<u>Expenses</u>	
Operating Expenses	\$ 0
Excess (deficiency) of revenue over expenses	<u>\$ 5,000</u>

By using deferred revenue, an organization can match the timing of the revenue and its related expenses. The income statement (or the worksheet list of pamphlet expenses) shows the expenses related to the grant, but to see "how much is left," managers must look at the deferred revenue section of the balance sheet.

Fund Accounting

Some organizations extend their ability to report by using fund accounting methods. Fund accounting is a type of accounting that is not universally required of all nonprofits, but which some nonprofits, because of the nature of their restricted monies, may find useful.

Fund accounting tracks not only the income and expense related to a certain project but the ways in which the resources themselves are held. In the language of accounting, a fund is a financial entity, almost a separate "mini organization" within the larger agency. While a fund may not have its own checking account, each fund does have its own revenue and expense accounts, and separate accounting for its own assets, liabilities, and fund balance.

The American Institute of Certified Public Accountants comments:

"While in some cases the organization's total resources may be available to finance its program activities, in many cases restrictions have been placed on certain of the assets by the donor, by law, or by other external authority, which prohibit their use directly or currently for operating purposes. Where such conditions exist, separate systems of accounts are often used to give recognition to the restriction . . . Under the fund accounting concept, separate accounting entities, or funds, are established as needed to achieve a proper segregation and fair presentation of those resources available for use at the discretion of the governing board (unrestricted funds) and of those resources over which the board has little, if any discretion as to use because of externally imposed restrictions (restricted funds)."

— *Audits of Voluntary Health and Welfare Organizations*, AICPA, 1974

Suppose that an organization is awarded a \$10,000 grant to publish a handbook. The handbook project will take about a year and a half. During the first year, the organization received \$7,500 of the grant (the last \$2,500 will be issued after the manuscript is at the printer's). So far the organization has spent \$7,300 of the money on the handbook.

EXAMPLE

Fund Accounting

BALANCE SHEET Year 1			
	General Funds	Handbook Funds	Total Funds
<u>Assets</u>			
Cash		\$ 200	\$ 200
Grants receivable		2,500	2,500
Investments			
Fixed assets (less depreciation)			
Total Assets		<u>\$2,700</u>	<u>\$2,700</u>
<u>Liabilities & Fund Balance</u>			
A/P			
Fund balance		\$2,700	\$2,700
Total liabilities and fund balance		<u>\$2,700</u>	<u>\$2,700</u>

STATEMENT OF REVENUE, EXPENSES & CHANGES IN FUND BALANCES Year 1			
	General Funds	Handbook Funds	Total Funds
<u>Revenue</u>			
Contributions			
Grants		\$10,000	\$10,000
Fees			
Total Revenue		\$10,000	\$10,000
<u>Expenses</u>			
Operating Expenses			
Excess for pamphlet	\$ 7,300		\$ 7,300
Total Expenses	\$ 7,300		\$ 7,300
Excess (deficiency) of revenue over expenses		<u>\$ 2,700</u>	<u>\$ 2,700</u>

Continued

Common Types of Funds

The most commonly used funds are the:

- Current Unrestricted Fund
- Current Restricted Fund
- Endowment Fund
- Land, Building and Equipment Fund
- Custodian funds

The **Current Unrestricted Fund** contains all assets and receipts which have no special restrictions. Sometimes also known as the Operating Fund or the General Fund, it accounts for resources which management controls to achieve the organization's purpose.

The board may commit portions of the current unrestricted fund for specific purposes; such designations are sometimes called appropriations, board-designated investment funds, or quasi-endowment funds. The use of board-designated funds may be helpful for internal control purposes, but since the board can also change or reverse its own action, board-designated funds are not restricted in the same sense as donor-restricted funds.

Current Restricted Funds are resources currently available for use only for those purposes specified by a donor or grantor. When organizations receive restricted gifts, they accept a legal obligation to comply with donor restrictions. Instructions from donors are verified by the auditor. Detailed accounting records must be maintained for all types of restrictions to assure that the donors' stipulations have been followed. While each restricted fund is tracked separately, the financial statements may report all current restricted funds as one group.

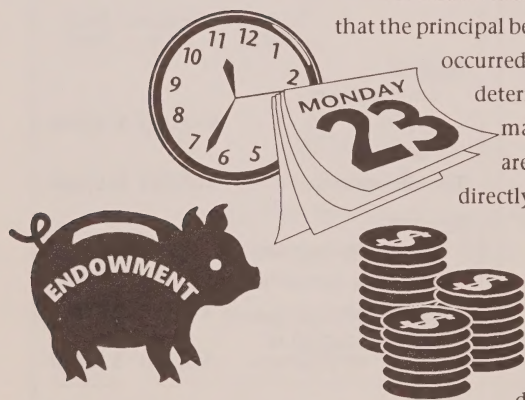
Correct handling of restricted gifts is very important; careful attention should be paid to the varied reporting requirements of donors and foundations.

An **Endowment Fund** is created when assets are donated with the stipulation that the principal be kept intact or maintained at its initial level until some event has occurred, such as the completion of a building's construction, or for a predetermined length of time. The use of earnings from that principal may or may not be additionally restricted. If additional restrictions are not present, dividend and interest income should be reported directly as income of the Current Unrestricted Fund.

In some cases, individual donors will create endowment funds that must be maintained as individually "named" funds. Often these can be grouped together for most reporting purposes and for investing. Records must be organized so that a separate income statement and a balance sheet could be produced for each individual fund.

The **Land, Building & Equipment Fund** (also called the Plant Fund or the Fixed Asset Fund) holds the investment in fixed assets, as well as any unexpended resources that have been contributed specifically for acquiring or replacing land, buildings or equipment.

Custodian Funds account for resources which are held by the organization but controlled by another person or organization. Examples include annuity funds and life income funds where the organization receives contributed assets and agrees to pay part or all of the



funds where the organization receives contributed assets and agrees to pay part or all of the earnings to specified individuals or organizations for a certain number of years. Short term custodian funds are commonly treated as deferred revenue in the liability section of the balance sheet. This allows transactions to be recorded without affecting income or expense accounts for the custodian organization.

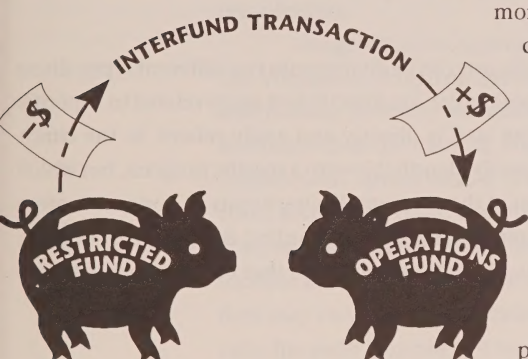


Borrowing from Restricted Funds

When an organization makes loans from one fund to another, or if it uses one checking account but has multiple funds, it must establish "Due to - from" accounts for each fund. This keeps track of inter-fund receivables and payables. Setting up the accounting system so that it can adequately track interfund transactions is important.

Unless a donor has specified otherwise, the restricted cash that is received cannot be spent for other purposes. Nonetheless, organizations in financial difficulty or with cash flow problems may find themselves borrowing from one fund to bridge temporary cash shortages in another fund. While organizations are free to have restricted funds borrow money from unrestricted funds, borrowing from restricted funds can be dangerous if expected monies do not materialize. If an

organization feels it must borrow from restricted monies, such action must be acknowledged and approved by the board of directors. The board should also approve and monitor a repayment plan for such inter-fund activity, recognizing the individual responsibility of directors to assure that donor restrictions are met.



In contrast to inter-fund loans, inter-fund transfers take place when resources are removed from one fund and placed in another fund. In some cases a restricted fund may be dissolved into the general fund at a date set by the donor. In other

cases, the board may transfer unrestricted funds into a sub-fund, such as a board-designated building fund.

Conclusion

As nonprofit organizations grow, their accounting systems often fail to meet their increasingly complex needs. In regard to both management and reporting needs related to restricted monies, organizations should consider:

- What departments should be established
- How and when restricted monies are received
- Whether these monies can be handled through deferred revenue accounts
- Whether fund accounting is required
- If so, what accounting structure will permit interim reports as well as provide a basis for the auditor to prepare standard financial statements.

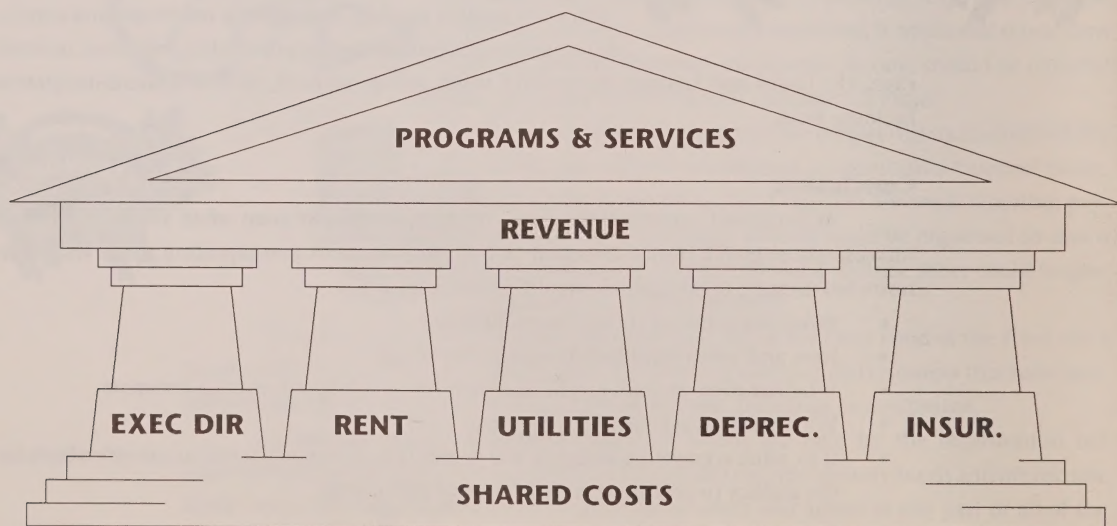
Indirect Costs and Cost Allocation

An additional accounting challenge faced by nonprofit managers has to do with allocating shared costs to the various programs of the organization to determine the full cost of each of the programs.

To begin with the context for discussions about indirect costs, imagine walking into a department store and asking to buy a \$100 table for \$65. "I only want to pay for the wood actually used in this table," you say. "I'll also pay for the 24 nails in the table, for the 2 ounces of varnish and the 3.5 labor hours that went into this table." The store manager rolls his eyes heavenward and tries to reason with you. "But at \$65 we lose money on the table," he says. "The price of the table has to include a share of our indirect costs such as management salaries, insurance, advertising, store maintenance, etc." You protest: "But I work in a nonprofit agency and some of our funders won't pay for indirect costs, so why should I?"

What Are Indirect Costs?

In a multi-program organization, all costs can be divided into two different types: direct costs and indirect costs. Direct costs are those which are directly and easily related to a specific program. For example, the cost of nursing staff is directly and easily related to the clinic. Indirect costs are those costs which are *not* easily identifiable with a specific program, but which are nonetheless necessary to the operation of the program. Indirect costs in nonprofits often include such line items as the executive director's salary, accounting & legal costs, utilities, rent, depreciation, and board-related costs—in other words, costs that benefit more than one program.



Because indirect costs are really costs that are shared by all the programs, they are often called *shared* costs. Classifying costs into direct and indirect costs is one system of classification used when determining the full cost of each program.*

Organizations frequently run into problems with indirect costs. For example, when planning a new program, a manager may write a budget for the program which is submitted to a foundation. That program budget may include salaries and supplies for the program, but may not take into account that portion of the additional overall costs that the agency will incur because of the program. For example, accounting costs may increase with additional staff on payroll; additional clients into the office may mean the receptionist can do less typing and so a half-time typist may need to be hired. If the organization does not request funds from the foundation for these shared costs, the organization may find itself in more financial trouble after receiving the grant.

In other cases, the funder may provide a set indirect cost rate, such as 10% of direct costs. The organization may be unsure which costs can be counted as direct costs and which must be subsumed in the indirect cost amount. (For example, some funders may require that telephone costs be subsumed as indirect costs while others may consider telephone costs as direct costs.) In some cases, the set rate may not cover the program's fair share of the cost of operating the organization.

Imagine that an organization is writing a grant proposal for a program to train Practical Life Volunteers to help people with AIDS. Direct expenses of the program may include printing and mailing publicity materials, renting a training room, and hiring staff to schedule the sessions and do the training. These direct costs may total \$15,000. The funder may specify that indirect costs cannot exceed 12%; indirect costs include the organization's rent and occupancy costs, accounting costs, and other costs that the funder does not consider allowable as direct costs of the program. When the organization receives the grant, it may be possible not to increase shared costs at first (or at least not more than 12% of \$15,000). For example, one more desk may be squeezed into existing office space, the receptionist may be able to handle more calls, the audit may not cost more, and the additional coffee and pencils purchased may not be significant. But if several such programs are added to the agency, costs will increase: more reception time will be needed, new office space and perhaps a new office manager may be required, bookkeeping time and audit costs will go up, etc.

In short, management of indirect costs must take place at two points: first in the budgeting process, and second in the accounting system. The methods used by the organization to account for indirect costs will guide the process of budgeting for indirect costs. In turn, the reporting requirements of the funders will guide the way that indirect costs are managed in the accounting system.

Some organizations preclude the use of indirect costs by treating all costs as direct costs. For example, a log may be kept of photocopies made and maintenance of the photocopier may

* This classification system should not be confused with other classification systems. For example, expenses can be divided into "Program," "Management & General," and "Fundraising" expenses in a system called functional expense classification.

EXHIBIT 19

Allocating Indirect Costs to Programs

The Tadpole League Illustration

\$3,300 TOTAL BUDGET		
PROGRAM A \$1,000	PROGRAM B \$2,000	INDIRECT/SHARED \$300

PROGRAM A \$1,000	PROGRAM B \$2,000
----------------------	----------------------

INDIRECT/SHARED \$300

PROGRAM A \$1,000	PROGRAM B \$2,000
----------------------	----------------------

\$100	\$200
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 INDIRECT/SHARED COSTS

The Tadpole League has a total budget of \$3,300. This budget can be broken down as follows:

	Prgm A	Prgm B	Indirect	Total
Direct	\$1,000	\$2,000		\$3,000
Indirect			300	300
	\$1,000	\$2,000	\$ 300	\$3,000

Since Program A's direct costs are 1/3 of the total direct costs of the agency (1,000 out of 3,000), it should bear 1/3 of the indirect costs. Similarly, since Program B incurs 2/3 of the total direct costs of the agency, it should bear 2/3 of the indirect costs as well.

After the indirect costs have been allocated to the programs, the budget now reads as follows:

	Prgm A	Prgm B	Total
Direct	\$1,000	\$2,000	\$3,000
Indirect	100	200	300
	\$1,100	\$2,200	\$3,300

be based on the proportion of copies logged by each program. Similarly, time sheets may form the basis for allocation of salaries such as that of the executive director or accounting staff. In some cases, organizations simply charge shared expenses (such as telephone or postage stamps) to the program that has money left in its grant. These methods of converting all costs into direct costs may work for small organizations with only a few programs, but quickly break down as the organization grows. Even for small organizations, such methods do not give management as much control or flexibility with cost management.

When shared costs are allocated to individual programs, two methods are commonly used to determine what proportion of shared costs will be allocated to each program: case by case allocation and allocation based on an indirect cost rate. Once the allocation method is chosen, the accountant may still choose from among several methods to handle the posting. It is critical that organizations with indirect costs shared by several programs have accounting expertise.

Briefly, case-by-case allocation is based on estimating a rate of actual usage for each program. For example, it may be decided to apportion the rent among programs according to the square feet used by each program. Telephone expenses may be divided among the programs based on the number of telephone instruments each program uses. A different method can be adopted for each line item or "case."

While this seems simple, a major disadvantage of case-by-case allocation is that it often requires a great deal of time-consuming record keeping. In addition, although the case-by-case method seems "rational," arbitrary selection of the measure often lies behind the allocation. If, for example, the rent is allocated by square feet, how should we allocate the hallway? The men's and women's restrooms?

Using an Allocation Rate

Other methods of allocation determine a rate by which indirect costs are proportionately distributed to the various programs. Allocation rates are based on the principle that if a program incurs 1/3 of all the direct costs of the organization, it should bear 1/3 of the indirect costs as well.

The first step in determining a rate is to separate all costs into two groups: a) the direct costs for each program; and b) the indirect costs that support the whole agency. The indirect costs are said to be "pooled" into an indirect cost pool and then allocated to the programs based on a set proportion, or rate.

There are several measures used to determine the proportion of indirect costs to allocate, or apply, to each program. In the Tadpole League example (see Exhibit 18), because Program A is responsible for incurring 1/3 of the League's total direct costs, Program A will bear 1/3 of the indirect costs as well. Using this ratio is called "using total direct costs as a base."

On the following page is an expanded example.

Continued

EXAMPLE**Determining an Indirect Cost Rate Using Total Direct Costs as a Base****THE POLLIWOG ORGANIZATION**

Suppose that the following represents all the expenditures of the Polliwog Organization during 1991:

Salaries	\$135,000
Rent	10,000
Telephone	4,000
Printing	45,000
Travel	<u>26,000</u>
Total	\$220,000

If the Polliwog Organization had only one program, there would be no need to establish an indirect rate, since all costs could be directly assigned to the single program. However, the Polliwog Organization has three programs: A, B and C. The following breakdown of costs has been made:

	<i>Program A</i>	<i>Program B</i>	<i>Program C</i>	<i>Indirect/Shared</i>	<i>Total</i>
Salaries	20,000	50,000	30,000	35,000	135,000
Rent				10,000	10,000
Telephone				4,000	4,000
Printing	4,000	12,000	25,000	4,000	45,000
Travel	<u>6,000</u>	<u>8,000</u>	<u>5,000</u>	<u>7,000</u>	<u>26,000</u>
Subtotal	30,000	70,000	60,000	60,000	220,000

The total direct costs of the programs are \$160,000 (30,000 + 70,000 + 60,000). So Program A's direct costs represent 18.75% of the total direct costs. Since we are using total direct costs as a base, A will then pay 18.75% of the indirect costs as well, or \$11,250 (.1875 x 60,000). Applying this method to Programs B and C, indirect costs are allocated as follows:

	<i>Program A</i>	<i>Program B</i>	<i>Program C</i>
Share of indirect costs	\$11,250	\$26,250	\$22,500

The same calculation for each program's indirect cost share can be reached through a different equation. In this approach, the proportion of total indirect costs to total direct costs results in an "indirect cost rate."

$$\frac{\text{TOTAL INDIRECT COSTS}}{\text{TOTAL DIRECT COSTS}} = X\% \text{ INDIRECT COST RATE}$$

$$\frac{\$60,000}{\$160,000} = 37.5\% \text{ INDIRECT COST RATE}$$

Then, each program's share of indirect costs can be calculated as a proportion of its direct costs:

Program A:	30,000	x	37.5%	=	11,250
Program B:	70,000	x	37.5%	=	26,250
Program C:	60,000	x	37.5%	=	22,500
					<u>60,000</u>

Allocating indirect costs using total direct costs as a base results in the following statement:

	Program A	Program B	Program C	Indirect/Shared	Total
Salaries	20,000	50,000	30,000	35,000	135,000
Rent				10,000	10,000
Telephone				4,000	4,000
Printing	4,000	12,000	25,000	4,000	45,000
Travel	6,000	8,000	5,000	7,000	26,000
Subtotal	<u>30,000</u>	<u>70,000</u>	<u>60,000</u>	<u>60,000</u>	<u>220,000</u>
Share of indirect costs	<u>11,250</u>	<u>26,250</u>	<u>22,500</u>	<u>(60,000)</u>	
Total costs	<u>41,250</u>	<u>96,250</u>	<u>82,500</u>	<u>0</u>	<u>220,000</u>

In addition to total direct costs, other bases that are commonly used are total direct salaries and total direct personnel costs. But less common bases may be used if another base is a better measure of each department's contribution to the general activity and scope of the organization. For example, a group of residential care homes may allocate indirect costs to each location based on the number of beds in each location.

These methods of developing an allocation rate are appropriate in organizations where each program or department benefits from the indirect costs in approximately the same proportion to the base. Where this is not the case, a "multiple allocation base" method can be used. In this method, similar indirect costs are grouped together into "pools," and each pool is allocated separately by means of the base that best measures the benefits accruing to the base. For example, an organization may allocate indirect salaries based on direct salaries, while non-salary indirect costs may be allocated on the basis of total direct costs.

When a Funder Doesn't Recognize Indirect Costs

Many funders and government agencies do not recognize indirect costs or indirect costing methods, saying, "We fund only programs, not overhead." From a different vantage point, indirect costs *are* program costs because they are essential and necessary to program operations. What makes them "indirect" instead of "direct" is that they are shared with other programs and are not easily differentiated and separated. The "true" cost of a program includes not only its direct costs (which are easily attributable) but also its indirect or *shared* costs (which are equally essential, but not easily attributable).

Continued

When a funder does not recognize indirect costs, the following process can be used to "itemize" a budget that was developed using indirect costing methods. This translates a budget into one that recovers the full costs of the program without a line item labeled "indirect costs." This process is called, "treating indirect costs as direct costs."

Let's look again at the Polliwog Organization and see how to itemize the costs of Program A using the same indirect cost rate determined above.

EXAMPLE

Itemizing Indirect Costs (Using Total Direct Costs as a Base)

THE POLLIWOG ORGANIZATION

Addressing the first line item, salaries, Program A should pay a share of indirect salaries in the same proportion as it incurs direct costs (because we are using total direct costs as a base). The Polliwog Organization's indirect salaries total \$35,000. Therefore:

$$\frac{\text{PROGRAM A TOTAL DIRECT COSTS}}{\text{ALL PROGRAMS TOTAL DIRECT COSTS}} = \frac{\text{PROGRAM A INDIRECT SALARIES}}{\text{ALL PROGRAMS TOTAL INDIRECT SALARIES}}$$

$$\frac{\$ 30,000}{\$160,000} = \frac{X}{\$35,000} \quad \text{so } X = \$6,563$$

Program A has salaries of \$20,000 which are easily attributable to its program. In other words, Program A has direct salary costs of \$20,000 and indirect salary costs of \$6,563 (as calculated above), making Program A's total salary costs equal to \$26,563. Using this method for each line item in each of the programs, the worksheet now reads:

The Polliwog Organization's budget with itemized indirect costs:

	<i>Program A</i>	<i>Program B</i>	<i>Program C</i>	<i>Indirect/Shared</i>	<i>Total</i>
Salaries	26,563	65,312	43,125	0	135,000
Rent	1,875	4,375	3,750	0	10,000
Telephone	750	1,750	1,500	0	4,000
Printing	4,750	13,750	26,500	0	45,000
Travel	7,312	11,063	7,625	0	26,000
Total costs	41,250	96,250	82,500	0	220,000

Although the total cost for each program is the same as in the first example, each program can now be presented in a way that includes the indirect costs but does not show them as a line item on the budget.

Note that when the budget presented is this way, the method of allocation cannot be inferred; furthermore, for a given program, we cannot tell which costs are direct and which are indirect.

If reports are required that show how the grant or contract funds have been used, the same process can be applied using actual direct and indirect costs to produce financial statements in the same format.

Choosing an Allocation Method

One reason for choosing a particular indirect costing method is to provide a more complete picture of the full costs of a program. In many cases, directives from the funding source may be the overriding factor. In other cases, managers may choose goals for the allocation system. For example, a rate might be chosen that loads the most indirect costs on a particular program, either because that program can better afford the indirect costs or because that program has more appeal to the public and can better generate contributions. When deciding upon an allocation method, finance managers should be aware that each method will encourage and discourage various management actions.

Conclusion

For the nonprofit organization, it's important to consider carefully all factors to make an informed decision on the allocation of indirect costs. For readers of financial statements, it's important to look beyond the reported rate or the amount of reported indirect costs when evaluating an organization's financial status. Contrary to popular belief, indirect costs are not an easy measure of an organization's efficiency or stewardship.

In fact, a high proportion of indirect costs may be an indicator of well-managed resources. For example, imagine a multi-service agency where each program had its own bookkeeper, purchased its own supplies, and had all its own equipment. Such an organization would have no indirect costs at all, but would be clearly less efficient than if the programs shared bookkeeping costs, supplies and equipment.

Funders and nonprofit organizations often have difficulty agreeing on how to think about indirect costs. Even within the same agency, the director, controller, and board members may find it difficult to communicate with each other on this topic. A common conceptual framework and language can make it easier for agreement to be reached, or at least for differences to be made clear.

Handling indirect costs in the budgeting process and in the accounting system is an important challenge for the nonprofit financial manager. Proper handling can result in recovery of the "overhead" costs essential to the agency's programs. At the same time, funders can be assured that they are funding the full costs of the programs they designate but not any more.

Questions and Answers Regarding Tax Compliance and Restrictions of 501(c)(3) Organizations

What Is a 501(c)(3) Organization?

This section discusses the important function of financial management — ensuring that the organization remains solvent, effectively and efficiently uses its resources, and complies with all federal and state laws regarding nonprofit organizations.

The term “nonprofit” covers a wide range of tax-exempt organizations classified under section 501(c)(3) of the Internal Revenue Code. A 501(c)(3) organization is one that is organized and operated for charitable, religious, educational, scientific, literacy purposes or for testing for public safety, fostering national or international amateur sports competition or prevention of cruelty to children or animals.

Some of the advantages of 501(c)(3) status include: exemption from corporate taxes on revenue earned in furtherance of tax-exempt purposes; eligibility for nonprofit bulk mail rates;

ability to offer tax-deduction to contributors; exemption from sales and real estate taxes in certain states; and eligibility for grants from foundations, corporations and government agencies who restrict their contributions to tax-exempt organizations.

501(c)(3) organizations are restricted by limits on lobbying activities and are prohibited to engage in political elections.

Disadvantages include: required annual information returns; limits on lobbying activities and prohibitions against engaging in political elections; prohibitions against distributing profits to individuals or members, and a legal obligation to turn over any remaining assets to another tax-exempt nonprofit should the organization dissolve.

Can Nonprofit Organizations Make a Profit?

Yes. Nonprofit organizations can make a profit. However, any surplus monies may be used only to further the organization’s purpose and may not be distributed to individuals or members.

What Is an Unrelated Business Activity?

A nonprofit organization can engage in unlimited activities that further its charitable purpose; however, the IRS states that only an *insubstantial* portion of the organization's activities may be devoted to activities that are *not* related to the organization's charitable activities. These activities are known as Unrelated Business Income (UBI). If a substantial part of its revenues is derived from unrelated business activity, an organization's tax-exempt status may be jeopardized.

Nonprofit organizations can make a profit. However, any surplus monies may be used only to further the organization's purpose

Unrelated Business Income (UBI) exceeding \$1,000 is taxed at regular corporate rates, with the exception of revenue derived from businesses primarily (at least 85%) staffed by volunteers and the sale of donated goods, which are excluded from taxation. Also excluded are occasional fundraising events such as annual dinners, bake sales, etc.

See IRS Publication 598 *Tax on Unrelated Business Income of Exempt Organizations* for more information regarding Unrelated Business Income.

What Annual Information Returns Must We File?

The following major Annual Information Returns are due to the IRS:

- **IRS Form 990 and Schedule A:**

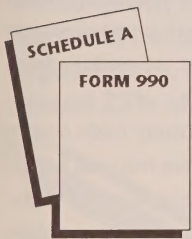
Return of Organization Exempt from Income Tax

Who Files: All 501(c) organizations with gross receipts exceeding \$25,000.

Purpose of Form: Reports financial information including Statement of Revenue and Expenses and Balance Sheet for past fiscal year. Also requests information on such things as program activities, certain contributions to the organization, and the names of board members. Schedule A includes supplemental information on the sources of financial support.

Due Date: 4-1/2 months after close of fiscal year.

Penalty for Not Filing: \$10/day for first 500 days.



- **IRS Form 990 EZ**

Who Files: Organizations with gross receipts of \$25,000 or more, but less than \$100,000 and end of year total assets less than \$250,000.

Purpose of Form: Shortened version of Form 990.

Due Date: 4-1/2 months after close of fiscal year.

Penalty for Not Filing: \$10/day for first 500 days.



- **IRS Form 990-T**

Exempt Organization Business Income Tax Return

Who Files: Organizations with Unrelated Business Income (UBI) over \$1,000.

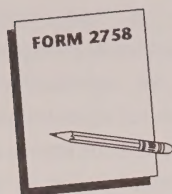
Purpose of Form: Filing of financial information for UBI.

Due Date: 4-1/2 months after close of fiscal year.

Penalty for Not Filing: Interest and various penalty charges



Continued



- **IRS Form 2758**

Application for Extension of Time to File

Who Files: Organizations wishing to extend deadline for Form 990 or 990EZ, Schedule A, and Form 990-T.

Purpose of Form: Filing extension.

Due Date: On or before due date of required forms (must be filed in duplicate).

Penalty for Not Filing: Denial of extension. Penalty for failure to file accrues as of the due date of Form 990.

In addition to these federal forms, most states require nonprofit organizations to file annual information returns. Please check with your state regulatory agency for specific forms and due dates.

What Payroll Taxes Are We Required to Withhold and Report?

Like any corporation, nonprofit organizations are required to withhold payroll-related taxes. Taxes paid by the employee include federal income tax (FIT) and the employee share of social security taxes (FICA); some states require the employee to pay state income tax, and disability insurance. Taxes paid by the employer include: employer share of Social Security taxes (FICA). Some states require the employer to pay disability insurance, state unemployment insurance, and workers' compensation insurance. 501(c)(3) organizations are exempt from having to pay federal unemployment insurance (FUTA).

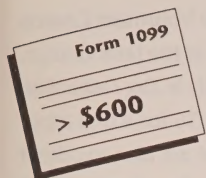
The IRS requires organizations to pay all withheld taxes on a timely basis and to report those withheld taxes using IRS Form 941. In addition, employers are required to give employees copies of the W-2 by the end of January, with copies of the W-2s and a W-3 to the IRS by the end of February. See IRS Circular E, *Employer's Tax Guide*, for withholding tax tables and deposit requirements for employers, and contact your state employment office for state requirements.

Failure to deposit taxes and file reports can result in severe penalties being levied against the organization, or the person or persons responsible for collecting and paying over those taxes.

Can We Pay People as Independent Contractors Rather Than as Employees?

According to the Internal Revenue Service, independent contractors are people who follow an independent trade, business, or profession in which they offer their services to the general public. You cannot decide to call a person an independent contractor in order to avoid the payment of the employer share of Social Security, state unemployment taxes, and workers' compensation insurance.

Whether an individual is an employee or independent contractor depends on the facts in each case. However, generally speaking, if you, the employer, have the right to control or direct the result of the work and the means and methods of accomplishing the result, then that person is an employee, not an independent contractor. Additional characteristics of employees include: working at your site and/or using your equipment, working exclusively for your organization, and working hours that the organization specifies. Additional characteristics of



contractors include: hiring and firing their own staff, registering a business name (dba) and having business licenses, investing time and money in on-going training, conferences, seminars, and reference books, and maintaining an identifiable work location.

An organization can be subject to severe penalties and charges for payroll taxes not paid if it classifies someone incorrectly as an independent contractor rather than an employee. If you have any question regarding the employment status of an employee, see IRS Form SS-8, *Information for Use in Determining Whether a Worker Is an Employee for Federal Employment Taxes and Income Tax Withholding*. The form lists all the criteria that the IRS uses in making such a determination.

Organizations must give all independent contractors who receive more than \$600 in a calendar year a Form 1099 and file a copy with the IRS.

Are 501(c)(3) Organizations Prohibited From All Political Activities?

501(c)(3) organizations are prohibited from participating in *electoral campaigns*, and can not engage in a "substantial amount of lobbying activities." Lobbying includes both attempts to influence the opinions of the general public about any legislation (grassroots lobbying, and/

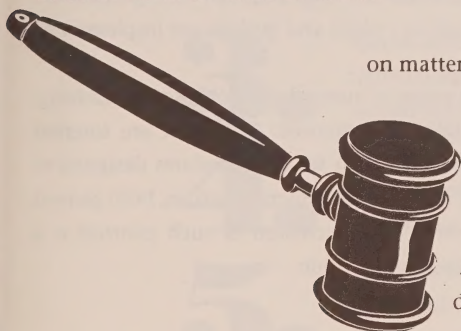
or communicating with any member or employee of the legislature or government officials who may participate in formulating that legislation.)

Lobbying does not include nonpartisan analysis, providing technical advice or assistance to a government body, or appearing before a legislative body

on matters which might affect the organization's tax-exempt status.

If a nonprofit does engage in lobbying, that lobbying cannot exceed 20% of all exempt purpose expenditures and grassroots lobbying cannot exceed 25% of that amount. In addition, if a nonprofit spends more than 5% of its monies on lobbying, it should file a Form 5768 *Election/Revocation of Election by An Eligible Section 501(c)(3) Organization to Make Expenditures to Influence Legislation* to declare that they are engaged in attempts to influence legislation.

If a nonprofit engages in lobbying, that lobbying cannot exceed 20% of all exempt purpose expenditures, and grassroots lobbying cannot exceed 25% of that amount.

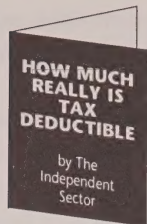


How Much Is Deductible to the Donor?

The IRS requires nonprofits to make very clear as to what amount of their contribution is tax deductible. According to IRS Publication 1391, *Deductibility of Payments Made to Charities Conducting Fund Raising Events*:

- The value of volunteer services cannot be deducted by the volunteer
- If a tangible benefit is received for a donation (e.g., a ticket to a performance, dinner, magazine subscription) only the amount above the value of the benefit may be deducted by the donor
- Payments for raffled tickets and bingo cards are not deductible as charitable contributions

Continued



Ask inquiring donors to speak with their own tax accountants. Local Volunteer Centers and United Ways often distribute guides to deductibility that are updated as the laws change. The Independent Sector has published an excellent booklet *How Much Really Is Tax Deductible*. Write the Independent Sector at 1828 L Street, NW, Washington, D.C. 20036 for a free copy.

The *Chronicle of Philanthropy*, *Nonprofit Times* and *Nonprofit World* are also excellent resources for up-to-date information on tax compliance issues. See Section on "Further Reading" for addresses.

Internal Controls

Nonprofit agencies, like all organizations, are vulnerable to deliberate theft and misguided use of funds for unauthorized purposes. But the same idealism and commitment that brings talented and committed individuals to the nonprofit sector may also make them reluctant to impose controls on trusted staff. Internal controls not only safeguard the organization's resources, but they work to ensure that an organization's plans and policies are implemented as decided.

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Because the scope of internal control is so far reaching, it is all too often taken for granted. Just what are internal controls? Internal controls are a set of procedures designed to promote and protect sound management practices, both general and financial. Following this discussion of such controls is a checklist agencies can use as a guide.

Why Have Internal Controls?

The objectives of a good system of internal control are:

- To provide reliable data: Managers depend on accurate information to make programmatic and other decisions. Program planning is influenced by the financial performance of the program as demonstrated in the financial statements. Internal controls ensure that financial information is reliable.
- To safeguard assets and records: Money and the physical assets of an organization can be stolen, misused, or accidentally destroyed unless they are protected with adequate controls. The same is true of non-physical assets such as pledges and accounts receivable, as well as important documents such as contracts, general ledger or property ledger.
- To promote operational efficiency: Controls within an organization reduce unnecessary duplication of effort and guard against misallocation of resources.

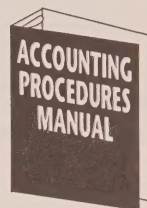
- To encourage adherence to prescribed policies: Management establishes certain procedures and rules to encourage the pursuit of organizational goals. Internal controls can help to ensure that these procedures are followed by staff.

General Practices

Depending on the size, number and nature of transactions in your organization, controls may be variously distributed. In a small organization, some overlap of duties will be necessary. A key principle is “segregation of duties”—no financial transaction should be handled by only one person from beginning to end.

A minimal set of internal controls might include:

- 1.** An Accounting Procedures Manual (APM) describes the administrative tasks of the agency and who is responsible for each. The APM doesn't need to be a formal document, but rather a simple description of how functions such as check issuance or transfers among funds are authorized and handled. Writing or revising an APM is a good opportunity to see whether adequate controls are in place.
- 2.** In many cases, two signatures should be required on checks, or two signatures required over a certain amount (example: \$500). Especially for all volunteer organizations, such as small AIDS service clubs or fundraising groups, this policy discourages embezzlement and encourages an atmosphere of accountability.
- 3.** Special attention should be paid to cash receipts, such as box office receipts and raffled ticket sales. The receiving of cash, its deposit and the posting of the income should not all be done by the same person.
- 4.** An annual budget should be approved by the board of directors and financial statements should be reviewed regularly by the board or the board's finance committee.
- 5.** The bank reconciliation should be done or reviewed by someone other than the signatories. Even a small organization can accomplish this by having the board treasurer review the reconciliation at a board meeting. As part of this task, attention should be given to payroll taxes and other payroll matters, major expenses, and outstanding liabilities.
- 6.** The board should approve all leases, loan agreements, affiliations, grant proposals and other major commitments of the organization. Normally, such approval would precede and accompany such documents.



The board should approve personnel policies which clearly define salary levels, vacation, overtime, compensatory time, benefits, grievance procedures, severance pay, evaluation, and other personnel matters. The section on “Staffing Patterns—Who Does What” elsewhere in this handbook gives examples for how responsibilities may be divided in volunteer organizations and in small, mid-sized, and larger organizations.

Continued

Audit Trails

A system of internal controls provides an audit trail. An audit trail means that a transaction (such as deposit or payment) can be followed from either end of the accounting system to the other—the original source document or the final record. For example, from a source document such as book order received, the auditor can follow how the transaction ended up in the financial statements. Similarly, any item on the financial statements can be traced back to documents verifying the nature of the transaction.

An auditor uses the trail as a testing mechanism to evaluate the internal controls and thus the reliability of accounting records. If sound *controls* exist, the auditor can place more confidence in the accuracy of the accounting *records* themselves. If the auditor decides that the controls are so weak as to make the accounting records inadequate, he or she may find it necessary to issue a qualified opinion, with the reasons described in the audit report.

BOOK ORDER RECEIVED ENTERED IN CASH RECEIPTS JOURNAL ORDER FULFILLED END OF MONTH TOTAL ORDERS POSTED TO GENERAL LEDGER INVENTORY OF BOOK STOCK TAKEN PROFIT/LOSS STATEMENT

Summary

Many nonprofit accounting textbooks include lists of suggested internal controls. In addition, accounting firms often distribute guidelines for internal control procedures. Internal controls do not, of course, guarantee that funds will not be taken or mis-used. Like a locked door, internal controls keep honest people honest. Internal controls also set a tone and a standard of accountability and conscientiousness. **Each volunteer and each staff member, by his or her actions and attitude, helps establish and maintain such standards.**

Internal Controls Checklist

	YES	NO	NOT SURE	NOT APPLIC.	Check one ACTION
CASH RECEIPTS:					
1. Are checks endorsed "For Deposit Only" immediately upon receipt?	☐	☐	☐	☐	_____
2. Are pre-numbered deposit slips used to record all monies received?	☐	☐	☐	☐	_____
3. Does someone prepare a daily list of all cash and checks immediately upon receipt?	☐	☐	☐	☐	_____
4. Is a Cash Receipts Journal prepared monthly that records the date of deposit, deposit slip number, amount of deposit, and name of payor with a columnar categorizing of revenue according to the Chart of Accounts?	☐	☐	☐	☐	_____
5. Are duplicate deposit slips retained for comparison to the initial list of receipts and the Cash Receipts Journal?	☐	☐	☐	☐	_____
6. Is the person responsible for cash receipts not the same person who reconciles the monthly bank statement?	☐	☐	☐	☐	_____
7. Are all cash and checks deposited in a Federally insured bank on a timely basis?	☐	☐	☐	☐	_____
8. If restricted funds are deposited in the same bank account with other monies, are the restricted revenues clearly identified in the Cash Receipts Journal?	☐	☐	☐	☐	_____
9. Is all cash received, counted and verified by two employees?	☐	☐	☐	☐	_____
10. When events involve admission fees, does the agency issue pre-numbered tickets, with a record of tickets printed, issued, used and unused, which is then compared to receipts?	☐	☐	☐	☐	_____
11. Has a copy of the list of all receipts been forwarded to the person responsible for accounts receivable and/or client and contributor records to ensure that all monies received have been properly credited to their accounts?	☐	☐	☐	☐	_____
12. Does the organization send acknowledgments to contributors?	☐	☐	☐	☐	_____
13. Are all disbursements, except those from petty cash, made by pre-numbered checks?	☐	☐	☐	☐	_____
14. Are voided checks preserved and filed after appropriate mutilation?	☐	☐	☐	☐	_____

Continued

	YES	NO	NOT SURE	NOT APPLIC.	ACTION
CASH DISBURSEMENTS:					
15. Is there a written prohibition against drawing checks payable to "Cash"?	☐	☐	☐	☐	_____
16. Is there a written prohibition against signing checks in advance?	☐	☐	☐	☐	_____
17. Is a cash disbursement voucher prepared for each invoice or request for reimbursement that details the date of check, check number, payee, amount of check, description of expense account (and restricted fund) to be charged, authorization signature, and accompanying receipts?	☐	☐	☐	☐	_____
18. Are all expenditures approved in advance by authorized persons?	☐	☐	☐	☐	_____
19. Does the checksigner review the cash disbursement voucher for the proper approved authorization and supporting documentation of expenses?	☐	☐	☐	☐	_____
20. Are signed checks mailed promptly?	☐	☐	☐	☐	_____
21. Are invoices marked "Paid" with the date and amount of the check?	☐	☐	☐	☐	_____
22. Are requests for reimbursement and other invoices checked for mathematical accuracy and reasonableness before approval?	☐	☐	☐	☐	_____
23. Is a cash disbursement journal prepared monthly that details the date of check, check number, payee, amount of check, and columnar description of expense account (and restricted fund) to be charged?	☐	☐	☐	☐	_____
24. Is check-signing authority vested in persons at appropriately high levels in the organization?	☐	☐	☐	☐	_____
25. Is the number of authorized signatures limited to the minimum practical number?	☐	☐	☐	☐	_____
26. Do larger checks require two signatures?	☐	☐	☐	☐	_____
27. Are pre-signed checks prohibited?	☐	☐	☐	☐	_____
28. Are bank statements and cancelled checks received and reconciled by a person independent of the authorization and checksigning function?	☐	☐	☐	☐	_____
29. Are unpaid invoices maintained in an unpaid invoice file?	☐	☐	☐	☐	_____
30. Is a list of unpaid invoices regularly prepared and periodically reviewed?	☐	☐	☐	☐	_____
31. Are invoices from unfamiliar or unusual vendors reviewed and approved for payment by authorized personnel who are independent of the invoice processing function?	☐	☐	☐	☐	_____
32. If the organization keeps an accounts payable register, are payments promptly recorded in the register to avoid double payment?	☐	☐	☐	☐	_____

	YES	NO	NOT SURE	NOT APPLIC.	ACTION
33. If purchase orders are used, are all purchase transactions used with pre-numbered purchase orders?	☐	☐	☐	☐	_____
34. Are advance payments to vendors and/or employees recorded as receivables and controlled in a manner which assures that they will be offset against invoices or expense vouchers?	☐	☐	☐	☐	_____
35. Are employees required to submit expense reports for all travel related expenses on a timely basis?	☐	☐	☐	☐	_____

RESTRICTED FUNDS:

36. Are restricted funds recorded in a way that accounts for and reports on those restricted funds?	☐	☐	☐	☐	_____
37. Are expenditures from restricted funds substantiated by adequate information indicating the nature of the restriction? Are expenditures, verified by the appropriate authorities after comparison to see that the expense meets the conditions of the restriction?	☐	☐	☐	☐	_____
38. Does the agency follow the policy of not borrowing from restricted funds?	☐	☐	☐	☐	_____
39. If there is any such borrowing, has it been determined that this is not in violation of donor restrictions or local laws?	☐	☐	☐	☐	_____
40. In the case of grants, are accounts periodically monitored for unexpended funds and are they promptly returned to the awarding party, if necessary?	☐	☐	☐	☐	_____

PETTY CASH:

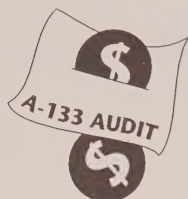
41. Is an imprest petty cash fund maintained for payment of small, incidental expenses?	☐	☐	☐	☐	_____
42. Does the agency follow a policy limiting the amount that can be reimbursed by the petty cash fund?	☐	☐	☐	☐	_____
43. Is supporting documentation required for all petty cash disbursements?	☐	☐	☐	☐	_____
44. Is a petty cash voucher filled out with supporting documentation, name of person being reimbursed, and proper authorization?	☐	☐	☐	☐	_____
45. Is access to petty cash limited to one person who is the fund custodian?	☐	☐	☐	☐	_____
46. Are unannounced counts of petty cash made by someone within the agency other than the fund custodian?	☐	☐	☐	☐	_____

Continued

	YES	NO	NOT SURE	NOT APPLIC.	ACTION
PAYROLL:					
47. Are detailed time sheets required documenting employee hours, including overtime?	☐	☐	☐	☐	_____
48. Are time sheets signed by the employee's immediate supervisor authorizing payment for work?	☐	☐	☐	☐	_____
49. Are employment records maintained for each employee that detail wage rates, benefits, taxes withheld each pay period, and any changes in employment status?	☐	☐	☐	☐	_____
50. Are payroll-related taxes (federal income tax, state income tax, employee and employer share of Social Security, and other taxes) withheld and paid to federal and state agencies on a timely basis?	☐	☐	☐	☐	_____
51. Do the executive director and the treasurer review all the payroll tax returns?	☐	☐	☐	☐	_____
52. Do written policies and procedures exist for accounting for vacations, holidays, sick leave, and other benefits?	☐	☐	☐	☐	_____
53. Is a list of all payroll checks written, with appropriate withheld taxes, maintained either through the Cash Disbursement Journal or a separate Payroll Register?	☐	☐	☐	☐	_____
54. Is a separate payroll bank account maintained?	☐	☐	☐	☐	_____
DONATED MATERIALS:					
55. Are donated services & equipment reported as revenue, with the appropriate offsetting expense?	☐	☐	☐	☐	_____
56. Is the valuation recorded at the fair market value or appraised value?	☐	☐	☐	☐	_____
57. Are donated materials properly recorded in and documented in the accounting system?	☐	☐	☐	☐	_____

	YES	NO	NOT SURE	NOT APPLIC.	ACTION
FIXED ASSETS:					
58. Are land, buildings, furniture and equipment recorded in a fixed asset ledger (inventory record)?	☐	☐	☐	☐	_____
59. Are inventory records maintained which list inventory item, serial number, location, date of acquisition, cost or (if donated) fair market value, useful life, depreciation/year, and accumulated depreciation?	☐	☐	☐	☐	_____
60. Are the inventory records reconciled with the General Ledger on a yearly basis?	☐	☐	☐	☐	_____
61. Is a physical inventory periodically taken by persons independent of the custodian function?	☐	☐	☐	☐	_____
62. Is the receipt, transfer, and withdrawal of inventory items promptly recorded in the inventory records?	☐	☐	☐	☐	_____
63. Are furniture and equipment worth over a certain amount (usually \$500 or \$1,000) listed in the accounting records as assets, unless funder requirements permit such items to be expensed when purchased?	☐	☐	☐	☐	_____
GENERAL AREA:					
64. Is a Chart of Accounts used?	☐	☐	☐	☐	_____
65. Are accounting records up to date, and monthly financial reports prepared on a timely basis (timely being defined as 10 days to 3 weeks maximum)?	☐	☐	☐	☐	_____
66. Does the Board of Directors approve the annual agency budget?	☐	☐	☐	☐	_____
67. Are the following financial reports made available to the Executive Director and Board on a regular basis (at least quarterly)?					
Balance Sheet?	☐	☐	☐	☐	_____
Statement of Revenue & Expense & Changes in Fund Balance?	☐	☐	☐	☐	_____
Cash Budget and Comparison to Actual?	☐	☐	☐	☐	_____
Comparison of Budgeted to Actual Revenue and Expenses?	☐	☐	☐	☐	_____
68. Does an accounting procedures manual exist that is reviewed and revised annually?	☐	☐	☐	☐	_____
69. Does the bookkeeper take an annual vacation?	☐	☐	☐	☐	_____
70. Have all appropriate federal (e.g., Form 990 or 990EZ, and Schedule A), state, and local information returns been filed on time?	☐	☐	☐	☐	_____

Audit Requirements for Recipients of Federal Awards



While a sound system of internal controls are imperative for all nonprofit organizations, nonprofit organizations that receive federal contracts and grants must comply with federal audit requirements and any other requirements of the grant or contract. In addition, as of January 1, 1990, most organizations that receive federal money are required to have a Certified Public Accountant (CPA) do an extensive, organization-wide, independent audit, at least bi-annually.

This bi-annual audit, known as an A-133 audit, is made in accordance with government auditing standards, and requires that the auditor determine whether the organization has:

- 1) Financial statements which fairly present its financial position in accordance with Generally Accepted Accounting Principles.
- 2) Internal controls to provide reasonable assurance that it is managing federal awards in compliance with applicable laws and regulations, as well as controls that ensure compliance with laws and regulations that could have a material impact on the financial statements.
- 3) Compliance with laws and regulations that may have a direct and material effect on its financial statement amounts and on each major federal program.

The copy of the audit report must be given not only to the organization receiving the audit, but the appropriate federal officials. These audit reports include the following:

- 1) Auditor's report on the financial statements and the schedule of federal assistance.
- 2) Auditor's report on the internal control structure.
- 3) Auditor's report on compliance—an opinion as to whether federal programs were being administered in compliance with laws and regulations. This would include a report on any illegal acts and/or irregularities.

Since January 1, 1990, organizations that receive federal money are required to have an extensive, organization-wide, bi-annual, independent audit performed by a Certified Public Accountant (CPA).

The organizational-wide, bi-annual audit is required for any organization that receives more than \$100,000 in federal awards. Those organizations that receive more than \$25,000 but less than \$100,000, can opt for either a bi-annual organization-wide audit or an audit only of each federal grant.

In addition, any subcontractor receiving more than \$25,000 is also required to show that it had spent the federal funds in accordance with all applicable laws and regulations.

The following is an overview of some requirements for nonprofits receiving federal assistance from such agencies as the Centers for Disease Control or the U.S. Department of Health and Human Services. The publications used as references include:

- Office of Management and Budget (OMB) Circular A-110, *Uniform Administrative Requirements—Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations*, issued July 1, 1976.
- Department of Health and Human Services Publication No. (OASH) 82-50,000 (Rev.), *PHS Grants Policy Statement*, issued January 1, 1987.
- Comptroller General of the United States, General Accounting Office, *Government Auditing Standards*, 1988 Revision.
- Office of Management and Budget (OMB) Circular A-122, *Cost Principles for Nonprofit Organizations*.
- Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Learning and Other Non-Profit Institutions*, issued March 1990. Circular A-133 supersedes Attachment F, subparagraph 2h of Circular A-110.

Test of Charges to Federal Awards

The criteria used by an auditor when examining the charges applied towards a federal award are outlined in OMB Circular A-122, Attachment A. These guidelines include:

- 1.** The charges are necessary and reasonable. A cost is reasonable if its nature or amount do not exceed that which would be incurred by a prudent person under the circumstances prevailing when the decision was made to incur the costs.
- 2.** The charges conform to any limitations or exclusions in the award. Any costs that violate the terms and conditions of an award are not allowed.
- 3.** The charges are given consistent accounting treatment and applied uniformly to both federal awards and other activities of the organization. Both federal and non-federal activities should receive the same accounting treatment.
- 4.** The charges are allocable to the federal award. A cost is allocable if it advances the work under the award, benefits both an award and other work, can be distributed equitably to benefits received, is necessary to the overall operation of the organization, and is otherwise allowed under the cost principles provided in *OMB Circular A-122*. An allocable cost of an award or other cost objective may not be shifted to other federal awards to overcome funding deficiencies or to avoid restrictions imposed by law or by the terms of an award.
- 5.** The charges are net of applicable credits. Any applicable credits, such as rental income, sale of assets, refunds, discounts, etc., should be used to reduce expense items allocable to federal programs.
- 6.** The charges are properly recorded and adequately documented. Evidence must support the expenses or costs, including the purpose for which it was incurred, date, amount of such cost, and approval by the appropriate management representatives.

Continued

7.

Special or unusual items are approved in advance. The organization received in writing an approval by the awarding agency before making special or unusual expenditures.

8.

The funder gives advance approval for certain types of expenditures such as the purchase of equipment and foreign travel.

9.

Personnel costs are properly recorded and distributed to federal and non-federal sources with supporting documentation for determining the charging of salaries and benefits to federal contracts, costs are appropriately approved and all fringe benefits such as payroll taxes, insurance, vacations, holidays, sick leave, pension, have been accrued.

10.

Unallowable costs are excluded from the Financial Status Reports FSRs submitted to the federal agencies. Costs which are generally considered to be unallowable include political activities, advertising, bad debts, depreciation on buildings or equipment fully funded with federal funds, entertainment, fines and penalties, fund raising, and interest.

11.

Indirect costs are charged appropriately and are fairly stated. Only allowable indirect costs are charged and no costs are charged to both an indirect cost pool and as a direct program costs.

12.

The costs claimed were included in the originally approved or amended budget.

Cash Management

An organization receiving money from a federal contract can receive its funds from one of three methods: an advance (cash request system), letter-of-credit system, or reimbursement.

An auditor, when reviewing an organization's cash management system, confirms that the cash receipts from federal awards were reasonable matched with expenditures, applied to proper accounts, and reconciled with expenditures periodically. The auditor also determines whether receipts from non-federal sources were credited to federal accounts if required by federal regulations and determine whether all interest earned on federal funds was properly recorded and remitted to the federal agencies unless otherwise instructed by the grantor agency.

Funds must be deposited in a bank which has Federal Deposit Insurance Corporation (FDIC) coverage. A sponsoring agency cannot require individual grant recipients to segregate federal cash in separate bank accounts, except when applicable letter-of-credit agreements have been made.

Property Management System

An auditor determines whether the organization maintains a property management system for its federal award programs. Some of the controls include:

- 1) Maintain detailed equipment records on a current basis. This record would include a description of the property, serial number, source of property including grant number, whether title vests in the recipient or the government, acquisition date, percentage at end of budget year of federal participation in the cost of the program for which the property was acquired, acquisition cost, ultimate disposition, and record of physical inventory.
- 2) Identify equipment purchased with government funds in order to avoid the commingling with the organization's other property.
- 3) Ensure that the organization obtained approval from the federal sponsoring agency for the use of real property in other programs when the property was no longer needed for the purpose of the original program.
- 4) Determine whether the physical existence of property was verified and compared with perpetual records on a regular basis.
- 5) Determine whether the organization met specific requirements relating to property as prescribed in contractual agreements.

Procurement System

In reviewing an organization's procurement procedures, the auditor is concerned with ensuring that materials and services are obtained in an effective manner and in compliance with the provisions of applicable federal law and regulations. Some of the procedures include:

- 1) Providing for competition in procurement practices.
- 2) Maintaining a standard of conduct which governs the performance of officers, employees or agents in the award and administration of contracts and grants using federal funds.
- 3) Avoiding purchasing unnecessary or duplicated equipment and evaluating lease-or-purchase options.
- 4) Reviewing subcontractors' and subgrantees' proposals and performance.

Program Income

The auditor also determines whether the organization is properly accounting for program income. This includes performing such tests to verify that the program income was utilized in accordance with the terms of the contract and that all interest earned on federal funds was reported and remitted to the federal agency, unless otherwise instructed by such agencies.

Continued



ABC PROPERTY
Serial No. 1234-5678
Grant No. 24M36-B
Acq. 3/23/90 CD2490

PURCHASE ORDER
No. 1003

Standards, an auditor, in reviewing an organization's internal controls, will determine whether the organization provides:

- 1) A clear assignment of responsibilities and accountability for planning, managing and controlling the functions of the data processing organization
- 2) Personnel that are qualified, adequately trained and supervised.
- 3) Proper separation of duties.

Such controls will help ensure that the organization's objectives are achieved, and that errors or irregular acts are prevented or detected.

The auditor also designs audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts. Irregularities and illegal acts include such matters as conflicts of interest, falsification of records or reports, and misappropriation of funds or other assets. Under guidelines of various AICPA Statements on Auditing Standards, the auditor has a responsibility to report such acts to the top official of the organization, or, if the official is believed to be a party to such acts, the auditor reports to an appropriate oversight body and, if illegal acts are involved, to the appropriate law enforcement authorities. *If the acts involve funds received from government entities, the auditor also promptly reports to the government audit officials.*

Budget Revisions

Recipients of government grants are usually allowed to make certain post-award programmatic changes and budget revisions. While grantees may rebudget within and between budget categories to meet unanticipated requirements, those revisions should be approved by the Grants Management Officer, unless the terms of the grant allow a certain degree of latitude without prior approval.

Management Systems & Procedures

Organizations are expected to have management systems, policies, and procedures in place for recording and managing of funds, equipment, and personnel before receiving federal grant support. Demonstration of an organization's management capabilities may be one of the evaluative criteria used in reviewing whether an organization will receive federal grant monies or have its grant renewed.

Audits & Reports By Independent Accountants

Financial reports are used by people within organizations (staff and board) and by people outside the organization (IRS, funders, regulators, contributors, stakeholders). Accounting standards, used by all organizations in external reports use a “common language” to ensure understanding and make it possible to compare the finances of one organization with another. Organizations may choose more informal or unique reports for internal use, but must issue standard reports for external use.

Should We Get an Audit?

The federal government requires independent audits only for organizations that have received more than \$25,000 in federal grants within the year. While some states require audits for all nonprofit organizations, most states do not. Government agencies may require a government or an independent audit for contractors, and some foundations may require audits of grantees. United Way member agencies are required to have annual audits.

If your organization’s financial statements are read by people who insist on the assurances of an audit, an audit is clearly a worthwhile expense. Some organizations that are cleaning up messy accounting systems will find an audit is invaluable in straightening out problems and setting a clear stage for future financial systems.

What Is an Audit?

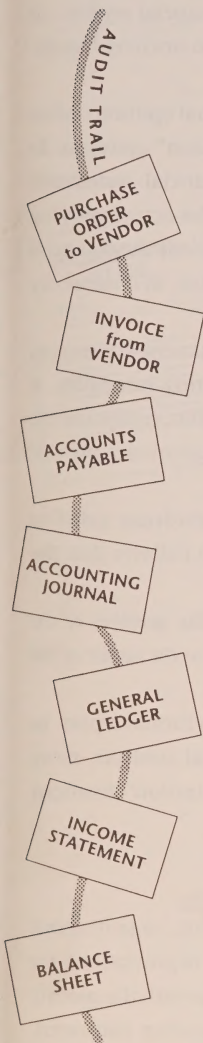
The word “audit” means different things in different contexts, but in accounting, an audit is a specific series of tests performed by an independent CPA, resulting in an opinion as to the accuracy of the financial statements.

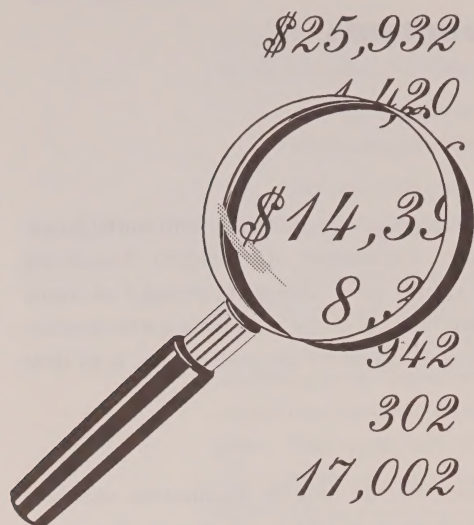
Independent accountants (accountants who are not staff members or board members, nor related to staff or board) prepare three basic types of reports: compilations, reviews and audits. Each report is concerned with whether the financial information presented in the statements is an accurate representation. The different types of reports reflect different levels of assurance from the accountant regarding that accuracy.

For a **compilation** report, the accountant takes financial data supplied by the agency and organizes it into standard financial reporting formats. The accountant does not review the numbers for accuracy, nor state an opinion regarding the accuracy of the information.

The accountant prepares a **review** after performing a limited examination of the numbers prepared by the agency. A review offers limited assurance that the organization’s true financial picture does not significantly vary from the information presented.

The most extensive examination of an agency’s financial records occurs as part of an **audit**. An audit may be described as a series of selective tests that give the accountant a basis for judging whether financial records can be relied upon. For example, auditors confirm bank





balances, look over selected donations to see that they were handled and recorded properly, review grant letters to see that receivables are accurately stated, etc. In addition, the auditor reviews physical assets, bank reconciliations, journals and ledgers, and board minutes. Based on this investigation, the auditor issues a formal opinion about the accuracy of the financial reports. (It should be noted that an audit is *not* designed to uncover fraudulent activity within the organization.)

Auditors can issue different types of formal opinions. Most often, audits are issued with unqualified or "clean" opinions. In these cases, the letter accompanying the financial statements includes wording such as: "In our opinion, the accompanying financial statements *present fairly* [emphasis added] the financial position of the XYZ Agency at December 31, 19xx, in conformity with generally accepted accounting principles."

A "qualified" opinion is issued when the accountant believes the financial statements are, in a limited way, *not* in accordance with generally accepted accounting principles. A qualified opinion might include wording, for example, such as, "In our opinion, except for the omission of the value of donated assets, the accompanying financial statements present fairly."

The accountant may issue a disclaimer of opinion if insufficient evidence exists to vouch for the financial statements, or an adverse opinion if the accountant believes that the financial statements are inaccurate.

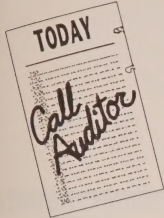
It is important to remember that an audit opinion does not address the question of the organization's financial health or long-term stability. Such assessments are left to the reader of the financial statements.

A management letter may or not be included as part of the auditor's formal report. In this letter to management, the auditor may recommend stronger internal controls, more emphasis on documenting receipts, or even comment on trends in the organization's financial history.

Selecting and Engaging an Auditor

Just as individuals seek doctors or attorneys by asking their friends, organizations usually begin the search for an auditor by contacting similar nonprofit organizations for referrals. Ideally, an auditor is familiar with nonprofit accounting and perhaps with the specific field in which the agency works (such as AIDS health contracts or housing contracts). Organizations often prepare a brief description of their accounting systems and send out letters to five or six accounting firms asking for bids. It's a good idea to solicit bids from sole practitioners or small offices as well as from large national accounting firms.

Accounting firms that are interested will send a representative to make a bid. The bid will be based on many factors, including the budget size of the agency, the condition of the



books, the complexity of the financial reports, the distance the accountant has to travel to the agency, the billing rates of the accounting firm, and the timeframe in which the audit must be completed.

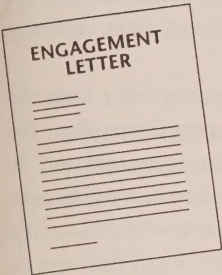
After receiving the bids, the agency may select and contract with an auditor. The auditor usually sends staff to work in the agency's office for a few days or perhaps a few weeks. The less work the accountant has to do (because the staff has done a complete job) the less the cost. In almost all cases, the auditor makes several adjusting entries to the work done by staff before the final financial statements are completed. Such adjustments are a normal part of the audit and not necessarily a reflection of poor staff work.

Preparing For the Audit

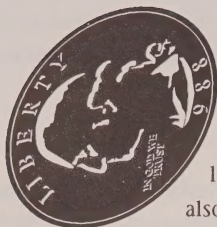
When you engage the auditor, ask him or her to give you a list of tasks to complete before the audit work begins. For example, the auditor may need a list of equipment along with serial numbers and dates purchased or a list of all open bank accounts. The auditor may ask for documents such as board minutes for the previous year, a copy of the Accounting Procedures Manual, or other procedural guides. The auditor needs to see documentation for any Accounts Receivable or Accounts Payable, such as letters from foundations awarding grants or invoices from companies. It is a good idea to reconcile bank statements, A/R and A/P schedules, and other ledgers before the auditor begins work.

In short, preparation for the audit has two focal points: first, putting things in order. Second, preparing documentation for items on the financial statements. In addition, accounting staff should be aware that they will need to spend time with the auditor and be available to answer questions.

Finally, working with an auditor is an opportunity to clear up any accounting problems from the year, improve accounting and control systems, and learn more about effective accounting. The auditor can be an important resource to your organization if you choose your auditor carefully and work to develop a cooperative relationship.



What Is Cash Flow?



While audits emphasize accuracy of financial statements and control, financial management is concerned with the broader area of using financial information to make better management decisions. Cash flow projections and management are crucial—and often neglected—parts of nonprofit financial management.

Everyone knows that if an organization has more expenses than income, sooner or later it will find itself in trouble. It is less obvious that an organization with net income can also have financial troubles. If the income and the expenses occur at different times, cash may not arrive in time to pay for the expenses as they become due.

In a simple example, imagine an organization with no cash reserves and a balanced budget, with \$10,000 in income and \$10,000 in expenses. If the income comes first, the organization will be able to spend down the \$10,000 in cash as expenses are incurred. If, however, the expenses come before the income, the organization cannot pay its bills.



The term “cash flow” refers to the need to have cash come in—flow in—at the right times so that it is available to flow out as needed. Cash flow can be projected, monitored and controlled. Cash flow projections are typically developed as part of the budget process, so that possible cash shortages or cash surpluses can be anticipated. As the year progresses, cash flow projections can be updated. As part of cash flow control, financial managers consider a variety of responses.

To meet a projected temporary cash shortage:

- Obtaining loans
- Arranging for a line of credit
- Speeding up collection of receivables
- Requiring fees be paid in advance
- Changing the timing of planned fundraising events or campaigns
- Financing the purchase of equipment
- Liquidating investments
- Working with funders for a more favorable payment schedule
- Delaying payment to vendors

To take advantage of a projected temporary cash surplus:

- Making short term investments
- Changing the timing of planned fundraising events or campaigns
- Making loans
- Buying supplies on sale that won't be needed immediately



Continued

Notice that these methods address the *timing* of cash inflows and outflows, as opposed to increasing income or decreasing expenses.

See Exhibit 21 below for an example of a cash flow budget that can be used to predict cash shortages and surpluses.

EXHIBIT 21

Sample Cash Flow Budget

JANUARY–DECEMBER 1991							
	TOTAL BUDGET	January	February	March	April	May	June
EXPECTED REVENUE:							
Government Grants	\$166,638	\$ 10,544	\$ 12,818	\$ 12,818	\$ 12,818	\$ 12,818	\$ 12,818
Foundation Grants	65,000	15,000	1,500	1,000	0	0	4,000
Contributions	28,000	1,500	1,500	4,000	3,500	2,000	1,500
Fees for Service	6,000	250	350	500	500	500	500
Special Events	8,000	0	2,000	0	0	0	3,000
TOTAL REVENUE	\$273,638	\$ 27,294	\$ 18,168	\$ 18,318	\$ 16,818	\$ 15,318	\$ 21,818
EXPECTED EXPENSES:							
Salaries	\$185,000	\$ 15,417	\$ 15,417	\$ 15,417	\$ 15,417	\$ 15,417	\$ 15,417
Fringe/Benefits	33,000	2,775	2,775	2,775	2,775	2,775	2,775
Occupancy	9,600	800	800	800	800	800	800
Supplies	5,400	300	2,000	300	300	1,300	300
Postage	5,800	850	150	150	850	150	400
Equipment	3,600	2,175	125	125	125	525	125
Travel	3,900	75	75	475	75	75	75
Telephone	6,200	700	400	400	400	400	300
Printing	3,250	1,075	75	75	575	450	275
Staff Training/Conf.	2,200	0	0	1,025	0	0	225
TOTAL EXPENSES	\$258,250	\$ 24,167	\$ 21,817	\$ 21,542	\$ 21,317	\$ 21,892	\$ 20,717
NET INCOME (LOSS)	\$ 15,388	\$ 3,127	\$ (3,649)	\$ (3,224)	\$ (4,499)	\$ (6,574)	\$ 1,100
Cash on Hand	\$ 9,468	\$ 12,595	\$ 8,946	\$ 5,722	\$ 1,223	\$ (5,351)	\$ 5,750
Loan (Investments or Payback of Loan)	0	0	0	0	0	\$ 10,000	\$ (4,250)
Ending Cash Available	\$ 9,468	\$ 12,595	\$ 8,946	\$ 5,722	\$ 1,223	\$ 4,649	\$ 1,500

Financial Indicators for Nonprofit Organizations

Just as a pilot checks the instruments for readings on where the plane is, how fast it is going, and in what direction it is heading, so nonprofit managers need to check their instruments—financial statements—to see how the organization is doing financially.

Calculate some of the ratios below. To see what direction you're heading, compare these ratios with those calculated six months ago or a year ago. Compare your ratios with the ratios of similar organizations.

Ratios That Help Assess Financial Standing

- **Short term liabilities coverage ratio**

Will there be enough cash to pay bills in the immediate or near future? Add together all assets that can be used to pay bills over a specific period of time, such as one month or three months. Compare this with the bills that must be paid within that same period of time:

$$\frac{\text{Cash} + \text{Unrestricted investments}}{\text{Current accounts payable and accruals}}$$

If high: there may be too much in cash; some could be earning more if invested.

If low: you may be in danger of a cash flow crisis—inadequate cash to pay pressing bills.

- **Current ratio:**

Will cash flow be adequate to pay bills over the next year?

$$\frac{\text{Cash} + \text{Savings} + \text{Cash to be received within the year}}{\text{Bills and expenses due within the next year}}$$

If high or low: same as above. Caution: even if current ratio is adequate, there may be periods within the year where there is inadequate cash to pay bills.

- **Debt to equity ratio:**

How much debt do you have compared with organizational net worth or fund balance (equity)?

$$\frac{\text{Total liabilities [both current and long term]}}{\text{Fund balance}}$$

If high: organization may have a dangerously high level of debt.

If low: organization may consider benefits of increasing debt.

- **Deferred revenue:**

Assuming that you do not record Grants Receivable or other receivable accounts with a corresponding Deferred Revenue amount, compare cash and savings with deferred revenue on the other.

$$\frac{\text{Deferred revenue}}{\text{Cash} + \text{Savings}}$$

If deferred revenue exceeds cash and savings, you may be spending restricted cash for purposes other than which the funder intended, or using monies designated for future purposes such as magazine subscription fulfillment.

Program Performance Indicators

Organizations with performance-based government contracts or that rely on service fees for revenue, often find the most helpful indicator is simply program performance. Such indicators can be provided regularly by program staff, and serve as a rough guideline as to whether revenue projections will be met. Examples of program performance indicators are:

- Number of clients enrolled in a therapeutic program last month and year-to-date
- Number of clients completing a training program
- Number of enrollments in workshops
- Beds filled last month and year-to-date

Where You're Heading

- **Cash flow budget**

Does the cash flow budget show adequate cash for each month?

- **Comparison of expense budget with actual expense**

Expenses that are higher than anticipated should be investigated. The variance can have several causes: a problem in control (better authorization procedures), uncontrollable increase in expenses (postal rate increase), change in plans (hired additional staff), etc. In some cases, measures may be adopted to stabilize expenses. In other cases, the implications of greater-than-expected expenses must be planned for.

- **Comparison of projected revenue with actual revenue**

Where revenue is lower than projected, the causes should be investigated and plans should be made to take into account decreased revenues.

Averages and Percents for Better Financial Management

- **Average days receivable** (average collection period): How long after you have rendered service is it taking your clients to pay?

Receivables x 365

Fee revenue

If high (longer than 45 days for example): consider strategies to speed up payments, such as requiring (or urging) payment on receipt of service, offering discounts for prompt payments (3% discount if paid in advance), or pursuing collections more aggressively.

If low: be glad.

Continued

- **Average days payable** (days purchases unpaid): List all your outstanding bills (excluding payroll) and how many days have elapsed since the bills were due or the invoices received.

Accounts payable x 365

Purchases

If high: (longer than 60 days for example): may be a warning that your cash flow and/or your financial health need attention.

If low: (sooner than 30 days for example): delaying payments slightly can help with cash shortages.

- **Percent return on investment:** Are your investments earning a satisfactory amount?

Income from investments

Average investment amount

If high: does the high income represent an unreasonable degree of risk?

If low: organization may not be earning as much on investments as it should.

- **Percent return on fundraising:** How cost-effective are your fundraising efforts?

Amount of contributions

Fundraising expense

If high: congratulations.

If low: examine fundraising operations. Can efficiency be improved. Should fundraising staff be given goals to which they are held accountable?

- **Liquidity:** compare cash (cash, savings) with other cash items (marketable securities, CDs).

If high: perhaps some should be transferred to higher-earning assets.

If low: consider liquidating some assets or planning for a cash surplus that can be used to increase liquidity.

Ratios That Help With Planning

- **Government independence:** how dependent are our activities on government funding?

Revenues from government contracts

Independently raised revenues

If high: the organization may be vulnerable to changes in government funding.

- **Vertical analysis:** Compare revenue line items as percentages of total revenue; and expense line items as percentages of total expense. For example, you may find that foundation grants constitute 40% of your revenue this year compared with 65% two years ago. What caused the change? What does this indicate about the funding environment? About your revenue strategy? In another example, you may find that personnel costs are now 75% of your budget where personnel costs were 85% last year and a similar organization reports personnel costs of 65%. What factors are reflected in the differences? Are adjustments appropriate?

PULLING IT ALL TOGETHER

Staffing Patterns: Who Does What

Each organization has a different mix of resources and each organization will assign responsibilities differently. Here are some common models that can serve as suggestions, rather than as prescriptions for a real situation.

Some small organizations choose to have transactions handled by staff, but the bookkeeping and accounting done by an outside accountant on contract. Larger organizations more typically keep financial functions on staff, although even some very large organizations work with contract accounting services.

Continued

EXHIBIT 22

Staffing Patterns

TASKS	VOLUNTEER GROUP <i>All volunteer, small organization. Books kept by the volunteer Treasurer.</i>	SMALL ORGANIZATION <i>5 full time staff, including one Administrative Assistant(AA) Monthly accounting work done by outside contract accountant.</i>	MID-SIZED ORGANIZATION <i>15 full time staff, including full-time bookkeeper.</i>	LARGER ORGANIZATION <i>30 full time staff, including full time finance manager, full time bookkeeper, half time accounting clerk.</i>
Open mail, stamp checks	President or person who receives mail	Receptionist	Receptionist	Accounting clerk
Make out deposit voucher	AA	Bookkeeper	Accounting clerk	Accounting clerk
Take deposit to bank	Treasurer or volunteer in charge of fund-raising	AA	Bookkeeper	Bookkeeper
Record deposit in books	Treasurer or volunteer who keeps books	AA records in checkbook; contract accountant prepares disbursement journal	Bookkeeper	Bookkeeper, reviewed by Finance Manager
Receive bills in mail	President; most bills submitted by volunteers at meetings for reimbursement	AA	Bookkeeper	Accounting clerk
Authorize bills for payment	President; most bills submitted by volunteers at meetings for reimbursement	AA if general invoice; people in charge of - specific areas may authorize payments in their areas	Department heads may authorize payments in their areas	Department heads authorize payments before check preparation
Make out checks	Treasurer	Bookkeeper	Bookkeeper	Accounting clerk
Signs checks	Treasurer & President	Executive Director	Executive Director	Finance manager or Executive Director
Other possible signators	Vice President, Secretary	Other management staff, board officers	Other management staff, board officers	Other management staff, board officers
Prepare payroll	No payroll	AA calls in payroll payroll to payroll service	Bookkeeper calls in payroll to service	Bookkeeper prepares payroll for review by Finance Manager
Post checks in books	Treasurer	AA fills out check stubs; contract accountant prepares journal	Bookkeeper	Bookkeeper
Reconcile bank statements	Treasurer	Board Treasurer	Department manager	Accounting clerk, reviewed by Finance Manager

TASKS	VOLUNTEER GROUP ORGANIZATION	SMALL ORGANIZATION	MID-SIZED ORGANIZATION	LARGER ORGANIZATION
Make General Journal entries, such as depreciation, adjustments; maintain General Ledger	May not use formal General Ledger	Contract accountant	Bookkeeper	Finance manager
Reconcile journals	Treasurer	Contract accountant	Bookkeeper	Bookkeeper
Run trial balance	Treasurer	Contract accountant	Bookkeeper	Bookkeeper
Prepare monthly financial statements	Treasurer	Contract accountant	Bookkeeper	Finance Manager
Complete quarterly payroll tax returns	No payroll	Contract accountant	Payroll service	Finance Manager
Monitor budget, propose changes	Treasurer	Executive Director	Bookkeeper with Executive Director	Finance Manager
Present finance reports to board	Treasurer	Executive Director	Executive Director	Finance Manager
Project & manage cash flow	Treasurer	AA may prepare	Bookkeeper with Executive Director	Finance Manager
Develop investment policy			Executive Director and Treasurer	Finance manager and Executive Director propose to Finance Committee and then to the Board
Meet with auditor	Not audited or Audit Committee	If audited, Executive Director and AA, contract accountant	Bookkeeper with Executive Director and Treasurer	Finance Manager, Treasurer
Prepare initial draft of budget	Board officers together	Executive Director	Executive Director with help from bookkeeper	Finance Manager
Approve budget	Board of Directors	Board of Directors	Board of Directors	Board of Directors
Prepare and file annual forms, including IRS Form 990	Usually too small to file	Contract accountant	Auditor	Finance Manager

Strategies for Financial Stability

Financial stability comes down to paying attention to three things.

First, develop reliable systems. Have an adequate accounting system and pay attention to the financial reports it produces. Have enough and skilled-enough staff. Bring financial information into your decision-making processes.

Second, develop short term plans. Draw up realistic annual budgets, commit to their enactment, and put people in charge of implementing and controlling the budget. Where finances diverge from the budget (either for reasons out of your control or by your decision), plan for the implications.

Third, develop long term plans. Outline a long-term financial strategy. This strategy will reflect the type of work the organization does, its client base, its constituencies, its internal organization, and the funding environment. Take control of your financial destiny.

The Accounting System

Just as a pilot must be sure that the plane's instrument panel is working properly, organizations must be sure that information from the accounting system is reliable. The system must properly track income and expense for both internal decision-making and for external watchers such as the IRS and foundations. Assets and liabilities must be reported in a meaningful way to expand internal management choices.

What constitutes an adequate system is decided jointly by fiscal staff, executive staff, the board, and the auditor. The organization must be committed to hiring skilled, experienced staff who have enough background and time to manage the system. This translates into adequate salaries, adequate staff and supervision systems.

When financial reports are being prepared, be sure that you use the valuable information in them. What do the statements say about your financial health? Financial trends in your expenses? Are problems on the horizon? What are the main causes of the deficit? What correcting steps are indicated?

Budget Control and Contingency Planning

A budget should be more than a guess at what the weather will be. A budget is a plan for how to accomplish certain objectives. Individual managers must consider themselves responsible (and be held responsible) for revenue and expense line items under their direction. If expenses are too high, correcting steps must be taken. If revenues are too low, correcting steps must be taken. By applying financial management skills, managers have many more options than simply cutting expenses or sending out an emergency fundraising appeal.

In uncertain environments, contingency planning is an essential part of financial stability. Contingency planning simply means, "What will we do if . . .".

If new funding is hoped for but not certain, make plans for how the organization will work if the funding does come through. What services will be expanded? What new services will be added? What additional support staff and systems will be required?

If funding cuts are anticipated, plan for one or two levels of service below your current levels. What services will be eliminated? Reduced? Consolidated? What staff will be laid off? What positions need to be changed? Making these plans in advance can alleviate the impact of the cuts, and you won't be making decisions in a rushed, emotionally charged atmosphere.

If you aren't sure how successful a new fee-for-service program will be, start the program with revenue benchmarks. If the new program doesn't generate at least \$10,000 within the first three months, for example, the new receptionist may have to be laid off. Conversely, if the new program generates more than \$15,000 in the first three months, you may decide to add additional staff to the accounting office.

Because the world is changing so rapidly around us, we need to be able to make rapid changes to keep up. Contingency planning allows for both quick changes and careful planning/deciding time.

Financial Strategies for Human Service Organizations

All organizations—whether for-profit or nonprofit—need financial strategies. For example, clothing stores can be successful selling different kinds of clothing. A store with expensive clothing needs a location where people shop who can afford expensive clothes. The decor of the store, the prices, and the type of salesperson must all complement the clothing style. A store selling inexpensive, trendy clothes requires a different location, different prices, different decor, different salespeople, along with different clothes. In short, all these factors must be put together into a winning package.

Human service organizations need long term strategies that put together successful packages. The components include: type of service provided, methods of raising funds, internal organization, location, staff profiles.

One organization's strategy may rest jointly on obtaining government contracts and improving operational efficiency. Such an organization realizes that its service priorities will be set by what government contracts are available and may focus on lobbying state legislatures for funding in needed areas. Another organization may center on fee-for-service programs. Responsive to client needs, this organization has to keep its costs and organizational structure flexible to be able to adapt to a constantly changing market. A third organization may rest its strategy on individual contributions obtained through large scale special events, and its services on those unable to pay. Such an organization has freedom to set its own program priorities, but must learn to keep both its upper-income constituency of donors and its lower-income constituency of clients.

What kind of organization are you building? What are the key, long-term factors that will make your organization succeed at its program work and stay financially sound? Not all of the AIDS organizations that exist now will survive the next five years. Those that succeed will be those with the strongest vision and those taking steps now to build for a strong future.

Continued

GLOSSARY OF ACCOUNTING TERMS

ICPA – American Institute of Certified Public Accountants. A governing body in the accounting profession. 1211 Avenue of the Americas, New York, NY 10036-8775.

Account – A specific type of asset, liability, fund balance, revenue, or expense. Examples: Postage expense account, Contributions revenue account, Prepaid Expense account.

Accounts Payable – A liability representing the amount due to others.

Accounts Receivable – An asset representing the amount due from others.

Accrual Basis Accounting – An accounting method where revenue is recorded when earned and expenses recorded when incurred. Modified accrual accounting allows for certain transactions to be recorded on a cash basis, while most are recorded on an accrual basis. Financial statements must be prepared on an accrual basis to conform with Generally Accepted Accounting Principles (GAAP).

Accrued Expense – Another term for accrued liability. Note this is a liability account, not an expense account.

Accrued Liability – A liability that has been incurred because an expense has occurred in an accounting period previous to cash payment. Example: accrued payroll expense.

Activity Statement – Another term for the Income Statement.

Assets – Tangible items that an organization has as resources, such as cash, accounts receivable, equipment, buildings.

Audit – An independent verification of the financial statements of an organization. An auditor tests, on a selective basis, the accounting procedures and internal controls of the organization.

Balance Sheet – The financial statement that shows the assets, liabilities, and fund balance of an organization as of a certain date.

Book Value – The difference between cost and the accumulated depreciation of an asset. The value of an asset that is showing on the books.

Cash – The name for money, whether in a bank account or in currency.

Cash Basis Accounting – A method of accounting where revenue is recorded when received and expenses recorded when paid. Modified cash basis accounting permits additional recording of certain transactions such as income tax withheld, where the incurring of the expense takes place at a different time from the related cash transaction.

Capitalization – The method of treating the purchase of equipment or other valuable asset as the acquisition of an asset rather than as an expense.

Chart of Accounts – A list of the accounts used, divided into five sections (Assets, Liabilities, Fund Balances, Revenue, and Expense), with each account assigned a different identifying number. The Chart of Accounts serves as a table of contents and coding system for bookkeeping.

Credit – One half of the accounting transaction in a double-entry system, a credit is shown on the right side of the record. A credit to a revenue account or to a liability account *increases* the amount in that account; a credit to an asset or expense account *decreases* the amount in that account.

Creditor – Someone who lends money or extends credit to the organization.

Current Assets & Current Liabilities – Current assets can be liquidated (converted to cash) within a short period of time, usually one year. Current liabilities must be paid within the same time period. Current assets include cash, accounts receivable, prepaid expenses, grants receivable (if the grant will be received within the fiscal period). Current liabilities include accounts payable, loans payable (if the loan is due within the fiscal period).

Debit – One half of the accounting transaction in a double-entry system, a debit is always shown on the left side of the record. A debit to an expense account or to an asset account *increases* the amount in that account; a debit to a revenue account or to a liability account *decreases* the amount in that account.

Deferred Revenue – Also called unearned income or contributions designated for future years. Income that has been received or promised prior to the time when it can be recorded as “earned.” Example: for a two year grant received in one sum during the first year, the amount for the second year would be recorded as deferred revenue.

Depreciation – A non-cash expense that accounts for the cost of using a fixed asset over time. Depreciation spreads the cost of assets such as buildings, equipment, and vehicles, over their useful lives.

Depreciation, Straightline – The method of depreciation where each year of the fixed asset’s useful life is charged an equal amount. Example: if a fixed asset costing \$5,000 is depreciated straightline over 5 years, each year will incur \$1,000 of depreciation expense.

Double-Entry Bookkeeping – A method that records all financial transactions through use of debits and credits. A double-entry bookkeeping system has checks and balances that provides a built-in audit trail. Each financial transaction makes at least two changes in the accounts, with debits equal to credits for each transaction.

Excess (Deficiency) of Revenue Over Expenses – The difference between revenue and expenses, representing the financial results (net profit or loss) based on all transactions in the period.

Expenditure – Outlay of money or incurring of a liability related to acquiring goods or services. Do not confuse with expense. For example, purchasing a fixed asset in one sum is an expenditure, but the expense of that asset will occur over the years depreciated. Or, an expense may be incurred when contracting for a purchase, but the expenditure will take place later when the invoice is paid.

Expense – Cost.

Financial Accounting Standards Board (FASB) – A governing body in the accounting profession. Publications Order Department: P.O. Box 5116, Norwalk, CT 06856-5116.

Financial Statements – The periodic presentation of financial information. The two primary financial statements are the Statement of Revenue, Expenses, and Changes in Fund Balance (also called the financial activity statement or the income statement), and the Balance Sheet. Other financial statements include the Statement of Functional Expense Classification, the Statement of Net Cash Flows, the Statement of Changes in Fund Balances, etc.

- Fiscal Year (FY)** – The annual (12-month) accounting cycle of an organization. Usually ends December 31 or June 30, but can end at any date in the year that coincides with the organization's operational cycle.
- Fixed Asset** – A tangible, noncurrent asset such as land, building, or sizeable equipment. Fixed assets are capitalized rather than expensed.
- Fund Accounting** – A method of accounting for restricted funds that classifies resources by the nature of the restriction, shows how those resources were used, and shows how they are held by the organization.
- Fund Balance** – The financial expression of what the organization is worth. The difference between the organization's total assets and total liabilities. Comparable terms: net worth, equity, net assets.
- Generally Accepted Accounting Principles (GAAP)** – The body of accounting principles which sets standards for organizations to follow. Modified by governing bodies in the accounting field, GAAP encourages uniformity in financial reporting.
- Internal Control Procedure** – A procedure designed to safeguard the organization's assets. Examples: requiring two signatures on checks, having a non-signatory prepare the bank reconciliation.
- Inventory** – Goods being held for sale.
- Journals** – Where bookkeeping transactions are first recorded (in chronological order) and categorized. From these "books of original entry," entries are posted (recorded) in the General Ledger. The three primary journals are the Cash Receipts Journal, the Cash Disbursement Journal, and the General Journal. Other journals include: Payroll Journal, Accounts Receivable Journal, Equipment Journal, etc.
- Ledger** – The book of the organization's accounts which shows monthly and cumulative summaries for each account. Known as the "book of final entry," it summarizes information from the journals.
- Liability** – Debt or amount due to a creditor.
- Net Assets** – Another term for fund balance or net worth.
- Net Income** – The "bottom line." The amount of income over expense. Also called the Excess of Revenue over Expense.
- Posting** – Recording the accounts affected in the journals. Also transferring information from the journals to the ledger.
- Prepaid Expense** – An expense that has been paid prior to the time it will be incurred. Example: a 12-month insurance policy paid in one sum at the beginning of the policy term.
- Revenue** – All income types including contributed and earned income.
- Support** – Contributed income.
- Transaction** – An event that is recorded in the bookkeeping system.
- Write Off** – To write off bad debt is to reduce the amount of the debt on the books to zero based on an assumption that it will never be collected. The amount of the reduction shows in that fiscal year as Bad Debt Expense.

FURTHER READING

MANUALS FROM SUPPORT CENTER workshops on financial topics (can be obtained from the Support Center of California, 70 Tenth Street, Suite 201, San Francisco, CA 94103):

- *Basic Bookkeeping for Nonprofit Organizations*, 77 pp, \$20.
- *Finance Files and Forms*, \$10.
- *Practical Financial Management*, \$20.
- *Budgets and the Budget Process*, \$20.

PUBLICATIONS OF THE AMERICAN INSTITUTE FOR CERTIFIED PUBLIC ACCOUNTANTS (AICPA: 1211 Avenue of the Americas, New York, NY 10036-8775) include:

- *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations, Statement of Position 78-10*, 1978.
- *Audits of Voluntary Health and Welfare Organizations*, 1974.
- *Audits of Colleges and Universities*, 1973.
- *Audits of Certain Nonprofit Organizations*, 1981.

Accounting and Financial Reporting: A Guide for United Ways and Not-for-Profit Human Service Organizations, United Way of America, 1974. Describes United Way procedures and guidelines.

Accounting Essentials: A Self Teaching Guide, by Neal Margolis and N. Paul Harmon, John Wiley & Sons, 1985.

Accounting for Nonprofit Organizations, by John Listro, Kendall/Hunt Publishing Company, Dubuque, Indiana, 1983.

The Audit Process: A Guide for Not-For-Profit Organizations, by CPAs for the Public Interest, 1989. Excellent. Available for \$8.50 from CSPI, 222 South Riverside Plaza, Chicago, IL 60606.

Beyond Profit, by Fred Setterberg & Kary Schulman, 1985. Published by Harper & Row, New York, 10 East 53rd Street, New York, NY 10022. This easy-to-read book covers all the bases and provides a good perspective.

Completing Your IRS Form 990: A Guide for Tax-Exempt Organizations, by Michael I. Sanders, Celia Rody and Andrew Lang. Published by American Society of Association Executives, 1575 Eye Street, NW, Washington, D.C. 20005, 1990. 77 pp. \$40 for non-members; doesn't include Schedule A.

Effective Internal Accounting Control for Nonprofit Organizations, 1980, Price Waterhouse, 6500 Rock Spring Drive, Bethesda, MD 20817.

Financial and Accounting Guide for Nonprofit Organizations, Fourth Edition, by Malvern J. Gross, William Warshauer, Jr., and Richard Larkin, 1990. John Wiley and Sons, New York, NY. A standard reference for accounting and financial management.

FINANCIAL ACCOUNTING STANDARDS BOARD (FASB), Order Department, P.O. Box 5116, Norwalk CT 06856-5116:

- *Statement of Financial Accounting Concepts No. 4, Objectives of Financial Reporting by Nonbusiness Organizations*, 1980.
- *Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements*, 1985.
- *Statement of Financial Accounting Standards No. 93, Recognition of Depreciation by Not-for-Profit Organizations*, 1989.

Financial Management in Nonprofit Organizations, by Richard F. Wacht, 1990. Georgia State University, Atlanta, GA 30303. Good material; second half emphasizes asset management.

Indirect Costs: A Guide for Foundations and Nonprofit Organizations by Rick Eden, David Lyon, Judith Payne, and Alan Brink. Published by the Rand Corporation, 1700 Main Street, P.O. Box 2138, Santa Monica, CA 90406-2138.

The Internal Revenue Service and state and local governments offer numerous publications, including from the IRS:

- #557—*Tax Exempt Status for Your Organization*
- #15, Circular E—*Employer's Tax Guide*
- Form #990 and Instructions—*Return of Organizations Exempt from Income Tax*
- Schedule A and Instructions—*Supplementary Information attached to Form 990*
- #561—*Determining the Value of Donated Property*
- #526—*Charitable Contributions*
- #598—*Tax on Unrelated Business Income of Exempt Organizations*

Making the Non-Profit Organization Work: A Financial, Legal and Tax Guide for Administrators, by Arnold Olenick and Philip Olenick, 1988. Prentice Hall, New Jersey. Good overview of all the basic legal and financial elements.

Management Control in Nonprofit Organizations, by Robert Anthony and Regina Herzlinger, 1980. Richard D. Irwin Press, Homewood, IL 60430.

Securing Your Organization's Future by Michael Seltzer. Published by the Foundation Center, 1987.

Self-Help Accounting: A Guide for the Volunteer Treasurer, by John Paul Dalsimer, CPA. Introduces financial recordkeeping for people without professional training in accounting or bookkeeping. Includes sample forms. Available for \$18.75 plus \$1.75 for postage and handling from Energize Books, 5450 Wissahickon Ave., Lobby A, Philadelphia, PA 19144.

Standards of Accounting & Financial Reporting for Voluntary Health and Welfare Organizations, Third Edition, 1988, by the National Health Council, Inc., the National Assembly of National Voluntary Health and Social Welfare Organizations, Inc., and the United Way of America. Nicknamed "The Black Book," a definitive authority for accounting and reporting in health and welfare agencies. Available through the National Health Council, 622 Third Ave., New York, NY 10017.

Teach Yourself Essentials of Accounting, by Robert N. Anthony. An interactive software program for both MS-DOS and Macintosh computers. Although oriented towards business accounting, the basic concepts are the same and some people enjoy learning through software modules. The software design is attractive and sound. Addison-Wesley Publishing Company, Route 128, Reading, MA 01867.

What a Difference Nonprofits Make: A Guide to Accounting Procedures, by Jude Kaye, Tom Lamothe, Jan Masaoka, and Barbara Miller. Accountants for the Public Interest, 1990. Written for accountants and business people volunteering and working in the nonprofit sector. Includes financial management concepts. Available free with \$5 for postage and handling: API: 1012 - 14th Street, NW, Suite 906, Washington, D.C. 20005, 202/347-1668.

The following magazines often carry articles on financial management and accounting:

Chronicle of Philanthropy, published bi-weekly, \$57.50/year, P.O. Box 1989, Marion, OH 43305.

Nonprofit Times, published monthly. Applications for free subscriptions can be obtained by writing to Nonprofit Times, P.O. Box 7286, Princeton, NJ 08543-7285.

Nonprofit World, published bi-monthly, \$59/year, published by the Society for Nonprofit Organizations, 6314 Odana Road, Suite 1, Madison, WI 53719.

NATIONAL MINORITY AIDS COUNCIL
300 EYE STREET, NE, SUITE 400
WASHINGTON, DC 20002